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# **Economics for Our Times**

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# Economics

STORY OF THE TRANSPORT OF THE

# for Our Times

# by AUGUSTUS H. SMITH

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CONSTITUTING EDITOR

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#### ECONOMICS FOR OUR TIMES

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THIRD PRINTING

# Preface

The past twelve years have brought changes that have greatly affected our way of living and working. Although some of these changes have been due to the great depression and more recently to the Second World War, many of them are of a permanent nature. During this period there has also been a great change in the subject-matter content of secondary-school texts and in the manner of presenting this material. This has been especially true of economics. Under these circumstances, a new textbook in economics seems called for.

It is the aim of this text to provide the student with an introductory survey of the principles of economics and of some of the major economic trends of the modern era. Considerable attention is given to the place of government in the economics of an interdependent world. Government is considered as a large business corporation carrying on many national enterprises. Its taxes, credit, and principal economic activities in behalf of the general welfare are discussed. A chapter on future economic possibilities growing out of present-day trends has been included. The major economic systems have been treated rather fully.

The book is divided into seven parts, each of which treats a major phase of our economic life. Much emphasis has been placed upon consumer interest and welfare; special problems dealing with personal, everyday economic matters have been given at the end of many chapters. It should be kept in mind that the author has treated in detail personal economic problems in his text "Your Personal Economics."

There is much less theory and a more practical application of economic principles than is usually found in a secondary-school text. The book is organized around the four economic activities: consumption, production, exchange, and distribution as they spring from the nature of human wants. The origin of these wants and their satis-

faction are examined for the light they throw upon such things as advertising, money and banking, markets, credit, and other economic tools. Such features of capitalism as private property, right of contract, free enterprise, competition, and cooperation are treated and compared with other economic systems. Trade barriers between the states are discussed for the first time in a secondary-school text. Labor problems have been brought up to date. The regulations and controls exercised during the war period have been considered in their proper places. Installment buying, deposit insurance, budgeting, insurance, and social security have been given prominence. A final chapter on war economics and reconversion brings the text up to the minute. It is hoped that a modern view of economic principles and problems has been achieved.

The style is simple and direct. The difficulties of students have been kept constantly in mind. Many helpful suggestions have been made by students and teachers. The value and interest of the book have been enhanced through timely pictures, cartoons, diagrams, sketches, and pictographs. An effort has been made to make the text interesting as well as instructive.

In addition to students and teachers, many others have aided in the making of the text. The author wishes to express his thanks to his colleagues who have been unsparing critics; to those publishers and authors who have permitted the use of material; and to the many business friends who have read parts of the manuscript and offered valuable suggestions.

AUGUSTUS H. SMITH.

Springfield, Mass., August, 1945.

#### ACKNOWLEDGMENT

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# List of Problems

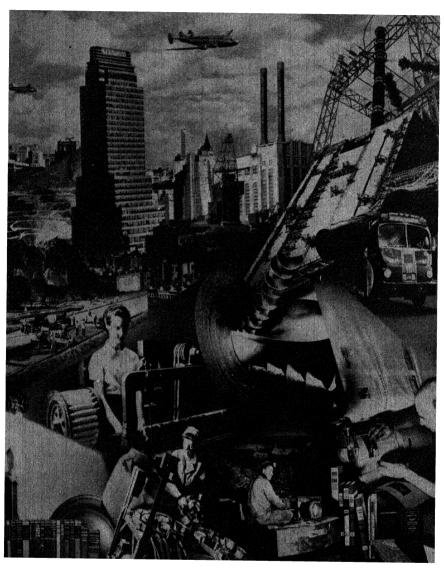
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# The Study of Business

Chapter I:

WE INTRODUCE OUR SUBJECT



ECONOMIC ACTIVITIES—Economics deals with the means by which men make a living—the office worker, the printer, the bus driver, the machine worker, and others all engage in activities that satisfy human needs.

# Chapter I

# We Introduce Our Subject

### Aims of This Chapter:

To understand what earning a living means.

To learn why people work.

To define economics.

To discover why it is worth while to study economics.

To examine the factors that affect us as we work.

As you begin the study of economics you are probably wondering what it is about and why you should study it. "Isn't it a dry and uninteresting subject?" "Isn't it hard?" The final answer to these questions will have to wait until you have completed the subject. But at the beginning we can assure you that economics should not be dry and uninteresting. Also it deals with matters about which you already have some knowledge. This first chapter will point out some of these matters and will attempt to arouse your interest in an important subject whose content is made up of problems involved in the business of earning a living.

Earning a Living.—In a small city somewhere in the United States lives the family of Thomas Brownell. It is composed of the father, the mother, and two children, one son and one daughter. The Brownells own their home, upon which there is a small mortgage. They also possess an inexpensive automobile for family use. The father owns and operates a garage and filling station, where he employs two assistants. In the conduct of his business Mr. Brownell finds that there are many problems that must be met. He must purchase gasoline, oil, and automobile parts, as well as the tools and machines necessary for his work. These tools and machines are expensive and he had to borrow money from the bank to pay for them. The bank requires him to pay interest on his loan. He must pay wages to his employees as well as social-security taxes, unemployment-insurance

taxes, and workmen's compensation insurance. He has to pay rent for the building in which he carries on his business.

In an effort to earn a living Mr. Brownell faces other problems. He must earn enough to pay taxes on his home, interest on the mortgage, reduction of the mortgage, insurance on the home and furniture, repairs on the home, and insurance on his own life. But this is not the whole story. In addition, he finds that he is required to pay a license to conduct his business, a tax on many things he buys, an income tax to the state and to the Federal government. Finally, he must earn enough above all these expenses to provide his family and himself with the necessities of life and some comforts. Mr. Brownell finds that it is no easy task to earn a good living.

But the father is not the only one concerned with the problem of earning a living for the family. The mother, too, has her tasks cut out for her. If the family is to live well and be happy, she must spend the income wisely. Upon her judgment in buying the commodities and services to satisfy the family wants depend to a large extent the happiness of the family and the success of her husband in business. She buys food, clothing, fuel, household equipment and furnishings, and hundreds of other things that add to the comfort and well-being of the family. The son has graduated from high school and has a good job in one of the local stores and is thus able to provide his own personal needs. The daughter is still in high school and must be provided with money for carfare, lunches, class dues, and many incidentals.

We have used the Brownells as an example of a typical family vitally interested in earning a living. But the example might just as well have been your own family. If you ask questions at home, you will find that your parents are struggling with the same problems as the Brownells. Payment of rent may take the place of paying taxes and interest on a mortgage, but there must be money paid for a home in either case. There may be other variations, but you will find that the problem of earning a living is the most important one in your family. One or more people must work and plan the use of income to make ends meet. To earn a living people must engage in work of some kind.

Why Do People Work?—From what has been said about the Brownells you have learned that most people work because they have to do so in order to satisfy the wants of those dependent upon them as well as their own wants. This is the main reason for engaging in



Keystone View Co.

FAMILY SPENDING—The Brownell family is discussing one of the problems of all families—the setting up of a family budget. Why is the cooperation of each member necessary if the budget is to be of any value?

work; it applies to the great majority of workers. But there are other reasons which inspire people to work. Let us examine a few of them.

Desire for Self-expression and Advancement.—This is a strong motive in causing many people to work. Nearly every normal person desires something more from his work than the mere money to provide the needs of himself and family. He wishes to provide opportunities for self-development. People, as a rule, are happier if they are able to enjoy some of the things that make living better. There are many who believe that happiness comes only through the enjoyment of those things which one possesses. But every normal being wishes to develop his abilities whatever they may be. The mechanic wishes to be known as a good mechanic, the lawyer as a good lawyer. Each takes pride in his work and strives to develop skill. You can see this in school. Although some pupils are satisfied if they get passing marks, there are many others who wish to do excellent work because of their desire to be outstanding pupils and to add to their knowledge.

Desire to Be Recognized and Approved by Others.—Down deep in most of us is a desire to gain the recognition and approval of those with whom we associate. Of course, there are some independent individuals who get satisfaction in meeting the standards they set up for themselves. Then there are those who do not care so much for what their fellowmen think of them but are willing to wait until the future passes judgment on their actions. Most of us, however, prefer to win the approval of our associates while we are still alive. There are various ways of winning this approval and recognition. Some try to gain it by amassing a great fortune; others seek it by spending money on a large scale. Some seek distinction by building up large industries; others prefer to win approval by using their wealth to establish scholarships, schools, colleges, hospitals, and other institutions which will render service to mankind. You will be able to think of several who have done these things.

Desire for the Welfare of Others.—So far we have mentioned desires which are more or less personal or selfish. But you know that there are many who work because they wish to provide for the welfare and happiness of others. This is true of your parents. Your father works primarily because he has to do so in order to provide for the needs of his family. Many times he has gone to work when he did not feel like working and often has performed tasks that were unpleasant and hard; he has performed extra work in order that someone in the family might be better cared for. Most parents make sacrifices throughout their entire lives in order that their children may have a better chance in the world than they had.

Outside the family group we find many who devote their lives to social work, which pays small wages. These people are working because they wish to make the lives of others happier and more useful. Those who seek to improve working conditions, to eliminate slums, to do away with child labor, and who engage in activities that make living conditions better for others, are working not merely to satisfy their own needs but from a desire to aid others.

These are not all the motives that prompt men to work; many others could be listed. Perhaps you will be able to add some incentives of your own.

What Is Economics?—In considering the various problems with which the Brownells and your parents are confronted in their efforts to earn a living, we have given a brief account of the field of economics.

Thus you see that economics is devoted largely to a study of the efforts of people to obtain incomes and to use these incomes in satisfying their wants. Economics is also concerned with the human relations which have been developed and which make up our economic society. To give you an understanding of the processes by which people get a living is the chief purpose of economics as a social study. Economics is the study that deals with the means and activities by which people get a living.

What Is to Be Gained from a Study of Economics?—Now that you know what economics is and with what it deals, you will want to know what advantages there will be in studying it. Let us examine a few of them.

It Will Give You Some Knowledge of the Business World.—Before long you will be leaving school to enter upon some business activity, to start earning your own living. If you have some knowledge of how business is carried on, of the principles of business practice, and of the business world in general, you will be more likely to succeed in your work. Economics explains the various principles that are the foundation of modern methods of manufacture and of the exchange of commodities and services. This knowledge will be of great help to you.

It Will Help You to Understand the Problems of Living.—A study of economics will help you to understand why everyone is affected in some way by what happens elsewhere in the world, why farmers are essential to our proper living, and why their problems should interest us. It will help you to understand why there are conflicts between workers and employers, why unemployment exists and is such a serious problem, why people must pay taxes, and why consumers find it difficult to solve their problems. Economics will aid you to understand why a war in Europe or Asia affects our trade and our living standards.

It Will Make You a Better Informed Citizen.—When you have learned something about banks, money, credit, taxes, tariffs, marketing difficulties, governmental finances, problems of old age, industrial conflicts, and the like, you will be a better informed voter because you will have some understanding of the issues being discussed. Economics will help you to gain this information.

It Will Aid You to Think Logically.—As you progress in your study of economics you will discover that it is not always possible to give a



Acme Photo

YOUNG VOTERS—Georgia recently passed a law allowing eighteen-year-olds to vote. Here are some high-school seniors registering to cast their first ballots. Economics has helped them to vote more intelligently.

single and simple answer to every problem. Economics requires careful weighing of many factors and circumstances; an economic problem may have several different solutions. As has been said, economics deals with human beings and their activities. It is not always possible to predict just how all people will act under similar circumstances. Thus you will have to weigh evidence, to consider many factors, and to choose between different proposals; in so doing reason counts more than snap judgment.

It Will Make You More Sympathetic toward the Problems of Others.— When you learn that all people do not live on the same standard, that many are struggling for a chance in the economic world, that the incomes of many are below the level of a decent living standard, that thousands lack even the things necessary to sustain them while they work, that fear of unemployment and of a dependent old age haunt thousands, you will be more tolerant of the efforts made by these people to improve their living and working conditions.

These are not all the advantages to be gained from a study of economics, but they should serve to show you that the subject deals with vital and interesting material. As your study continues you will be able to add many more reasons why the study of economics is worth while.

What Are the Factors That Affect Our Economic Activities?— Most working people carry on their daily activities without giving much thought to the conditions and factors that influence these activities. In most cases these conditions are never called to their attention. Nevertheless, there are many factors that determine what we shall do, how we shall do it, and what we shall get for our work. It will not be possible in this book to discuss all the factors that influence our working habits, but we can explain a few of the more important of them.

We Are Influenced by Our Surroundings.—In your school activities you have no doubt noticed that you can do better work if the study hall and the library are quiet and if everyone around you is busy at some task. Comfortable scats and clean rooms, capable teachers, and pleasant companions add to the ease with which you learn your lessons. Pleasant home surroundings likewise send you out in a happy mood. If these things make such a difference to you in your schoolwork, what effect do you think surroundings have upon your parents as they work? They, too, are able to do better work and are less tired at the end of the day if their surroundings at the factory, in the store, or in the office are pleasant. Many employers have recognized this influence and have made their factories and stores pleasant places for workers; they have installed many features which add to the comfort of the workers. They find that these changes lead to more contented workers and fewer labor troubles. Surroundings in the home, in the factory, in the office, and in social life affect our activities more than we realize.

Want-satisfying Goods Are Relatively Scarce.—Whatever may be the motive that prompts people to work, the fact that their wants are never completely satisfied is constantly before them. This is due to the fact that there never seem to be enough goods at any given time and place to satisfy all wants for them. There are many reasons for



Courtesy of Resettlement Administration, Photo by Mydai

ENVIRONMENT—Contrast the pleasant surroundings of the homes at the to with the squalor of the miners' homes, flanked by burning slag piles. What story d these houses tell about the people who live in them?





this scarcity. Enough may not have been produced because of floods, frosts, pests, droughts, or other causes. Or it may be that so many people are trying to live in a region that all cannot have what they need. There are other causes but, whatever they may be, the fact remains that this scarcity stimulates people to work harder. Even though some goods exist in abundance, they are not to be had for nothing. People must work to earn the money with which to purchase them. Even then they often find that they are not able to purchase enough to satisfy all their wants. Until the time comes, if it ever does, when want-satisfying goods exist in sufficient abundance to satisfy all wants for them, the relative scarcity of these goods will be an important factor in compelling people to work for a living.

We Are Dependent upon One Another.—Your parents are aware that they cannot produce all the things the family wants. There was a time when the family was almost a self-sustaining unit but that time has gone forever. Our wants and needs are so many times more numerous than they were one hundred years ago that no one person can possibly produce anywhere near what he needs. So what has happened? Today your father goes to the office or the factory to do work that is needed. He produces a part of a product or a service that someone else wants. While he is doing this, someone else is working to produce the things he needs. Your father is doing what he is best fitted for and depends upon others to supply what he wants. This interdependence is a prominent characteristic of our economic world.

This economic interdependence is not confined to local communities but is found throughout the entire world. If a worker anywhere who is producing commodities or services needed by others fails to do his part, some worker in some other country may be unable to get what he wants. We become conscious of this economic interdependence whenever a serious strike occurs in an essential industry. Think what would happen to you and your family if the bakers supplying your community failed to produce any bread. The Second World War made us very conscious of our dependence upon others when we were deprived of rubber, tin, silk, and many other essential commodities. Not only was our war effort hampered for a time but our living habits were completely changed.

Private Property and Inheritance.—Your parents are willing to work hard and to save money in the hope that they may some day be able

to own a house and to live comfortably when they are old. They keep on working because they want to possess property of their own. Not only do your parents hope by hard work to possess some private property during their lifetime, but also to hand this on to their children when they die. This is called the "right of inheritance."

Government places certain restrictions upon the use that may be made of private property and also takes a share of this property before it is passed on to the heirs if it is above a certain amount. Your parents are not permitted to use their property in such a way that it interferes with other people's enjoyment of their property. They will be obliged to pay taxes to the government and may be called upon to surrender some of their property to the government if it is found necessary to take it for some public use. But the government pays a fair price for any property taken for this purpose. If one owns and drives a car, he must first obtain a license to do so and must observe certain laws regarding speed, condition of brakes, lights, etc. He must pay a tax for the use of the car and for the gasoline he uses to operate the car. While all these regulations restrict the use of private property, they are imposed in the interests of the general public.

We Are Free to Engage in Any Occupation We Choose.—When your parents were ready to engage in work, they were not told what they could do or could not do. They were free to engage in any activity they chose. This same privilege is open to you. But this right is also subject to certain restrictions. You will not be permitted to engage in some occupations without first obtaining a special license. This applies to the selling of drugs and certain foods. Although you are free to study law or medicine, you will be required to meet certain qualifications and to pass rigid examinations before you will be allowed to engage in practice. If you wish to teach, you will find that many states and cities now require you to obtain certain degrees in educational subjects and to pass examinations. These restrictions are not meant to prevent anyone from entering these occupations but are imposed in the interest of the public and to see that only qualified persons serve the public.

We Are Free to Enter into Binding Agreements.—When a person buys a house or leases it from someone else, he enters into an agreement that binds both parties to certain conditions. This agreement is called a "contract," and its terms can be enforced at law in case either party to it violates those terms. If a person borrows money, he will



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REQUIREMENTS FOR PROFESSIONAL MEN—With certain restrictions, you may engage in any activity you choose. These law students are studying in preparation for an examination in law. They must fulfill certain qualifications before they are permitted to practice.

be called upon to sign a note promising to pay back the money with interest. This is another kind of contract. It is a characteristic of the world in which we live and work that every competent and mature person has the right to make binding agreements which are enforceable at law. Of course, an agreement that is against public good cannot be enforced. For example, no one would be allowed to enforce an agreement to burn another's house to gain the insurance. Such agreements would be criminal conspiracies, not lawful contracts.

Competition Is Keen.—Many other persons in your city or town may be engaged in the same occupation as your father. If they are workers, they are competing for jobs; if they are in the business of selling goods, they are competing for customers. Competition is present almost everywhere and, to succeed, a person must do better work than someone clse. Competition exists among those who work and produce goods, among those who sell goods, and also among those who buy goods. It is a wholesome stimulus to work.

The Profit Motive Prevails.—Although this has been placed last in the list of factors that stimulate us to work, it is by no means the least important. Indeed, the desire for profits is the chief motive behind the establishment of most businesses. If there were no profits to be made in a business, it would be abandoned. Under our economic system our material well-being depends upon the amount of money we make. Hence we conduct our business affairs with the purpose of making a profit. Sometimes this leads to unfortunate results, as when human happiness and social well-being are sacrificed to the profit motive.

Summary.—Because economics deals with the activities of human beings as they strive to earn a living, it is an important and interesting subject. Earning a living is not the simple affair many believe it to be. It has to do with such varied and difficult matters as money, banks and credit, commodities and services, prices, wages and employment, markets, taxes, trade, and a host of other problems. People must work if they are to satisfy their wants, and this is why most of us do so. But some work for other good reasons, such as a desire for self-development, a desire for power and influence, a desire for the approval of others, and a desire to help others who are not so well situated.

Economics is the social science that deals with the means and activities by which people earn a living. It is a social science of business; it deals with the activities of people in groups rather than as individuals. From its study you will gain a knowledge of the business world, learn to understand the problems of living, become a better informed citizen and voter, learn to think more logically, and develop a more tolerant and sympathetic attitude toward the problems of others.

There are many factors in the economic world that have an important influence upon how we shall live, what we shall do, how we shall do it, and what we shall receive for what we do. We are influenced by our surroundings and by the fact that want-satisfying goods do not exist in quantities sufficient to gratify the many wants of all at any one time. We are dependent upon others for most of the things we need and enjoy; we must cooperate with others if all are to receive the things that make life worth while. Competition is keen and acts as a spur to our economic activities. We are assured of the right to own and use private property and to pass it on to others when we are through with it. We are free to engage in any occupation we choose,

provided it is not harmful to the welfare of others and provided we can meet the requirements set up; we may enter into agreements with others, provided these agreements are not against the public good. Finally, our system is based upon the profit motive. All these characteristics of society affect our choice of tasks and our attitude toward our work.

# Questions to Test Your Knowledge

- 1. List some of the problems people face in making a living.
- 2. What is the chief motive that impels people to work?
- 3. Name some other reasons why people work.
- 4. Give a definition of economics.
- 5. List several advantages to be gained from studying economics.
- 6. How can a study of economics help you to become a better informed citizen and voter?
- 7. Show that economics can help you to think more logically.
- 8. What is meant by saying that want-satisfying goods are relatively scarce?
- 9. Explain how we are all economically interdependent.
- 10. Why is the use of private property restricted?
- 11. What restrictions are there upon your freedom to choose your life work?
- 12. What is competition?

# Questions for Discussion and Application

- 1. Why is earning a living sometimes referred to as a "struggle"?
- 2. Why is the desire for self-expression and improvement so strong in us?
- 3. Discuss the effect of environment upon our economic activities.
- 4. What is meant by saying that even though economic goods were abundant they still would not be free?
- 5. Discuss the statement that we are economically interdependent. Give several examples to show this interdependency. May this interdependency ever become a disadvantage? Explain.
- 6. Make a list of occupations you would like to enter. Would you be free to enter these occupations without restrictions? What restrictions are placed upon any of them? Do you consider these restrictions just?
- 7. Do you believe that all workers are dominated by the profit motive? Try to name some workers who are not so motivated.

8. Are voters intelligent when they vote for candidates who stand for ideas and economic principles that are not clear to the voters themselves? Explain.

## Floor Talks and Written Reports

- 1. Essentials for satisfactory living.
- 2. The implications of economic interdependence.
- 3. Motives that cause people to work.

## Topic for Debate

RESOLVED, That economics should be required of every high-school pupil before graduation.

# For Further Information

On pages 495–501 will be found a detailed bibliography, giving the full title and date of publication of each of the books listed. At the end of each chapter only the name of the author, the title of the book, and in some cases the page or chapter references will be given. Consult the Bibliography for further information.

Chase, Stuart, "A Primer of Economics."

Deibler, F. S., "Principles of Economics," Chaps. 1, 2.

Gemmill, P. F., "Fundamentals of Economics," Chap. 1.

Kiekhofer, W. H., "Economic Principles, Problems and Policies," Chaps. I, II.

Scherman, H., "The Promises Men Live By," Introduction.

#### PROBLEM 1

# How Useful Is Economics?

It is claimed that most people are not intelligent voters because they know so little about the issues and problems that are discussed during campaigns and periods of stress and emergency. Although this may be true of many political problems, is it wholly true of economic problems? There are many who claim that it is truer of economic problems than it is of other problems. A glance at the newspapers and magazines will show that most of the problems being discussed throughout the country today are of an economic nature. Among these we find price fixing, rationing, subsidies, taxation, inflation, strikes, labor legislation, foreign trade, raw materials, regulation and control of business, transportation, governmental financing, feeding the world, and many more. How many voters understand these problems

and their implications? How much do our legislators really know about them?

There seems to be an assumption that the average citizen knows enough about them to vote for some candidate who will help to solve them for him. But matters of health and safety are not decided in this way. When a new bridge is to be built, a new type of battleship to be developed, a new airship for transporting goods and persons to be planned, or when an epidemic of influenza breaks out, people are not asked to vote for the persons to handle these matters. For these purposes experts are chosen, men who have devoted much time, study, and practice in the particular field in question. If experts are needed to solve important problems of health, safety, and protection, why should there not be experts to solve our economic problems? Some say that, since citizens in a democracy are privileged to vote on economic matters, more education in economic principles should be required of everyone. An understanding of the basic principles of economics will help make us better informed and enable us to act more wisely in the choice of men to make our laws and spend our money.

- 1. Who is an "intelligent" voter?
- 2. Is the average person wholly ignorant of the essential problems of living?
- 3. Do people as a rule read and study current problems to any extent? Or do they prefer to be told by some commentator about these problems?
- 4. Would we be better off if we knew more about the problems of money and prices?
- 5. Would it be better if we had trained economic experts to solve our economic problems just as we have doctors and engineers to solve the problems of health and safety?

#### PROBLEM 2

## Budgeting the Family Income

Thomas Brownell is chiefly concerned with making a living for himself and his family. The profit he makes from operating his business furnishes the income upon which his family lives. In addition, his son, who is regularly employed, pays \$25 a month toward the family expenses. Mr. Brownell knows that by planning his income and expenditures, he can get more for his money and also keep out of debt. In estimating his expenditures, Mr. Brownell uses as a basis his last year's total income, which was \$3,400. He does not wish to have too many items to keep track of and so decides upon six. Under savings he includes life insurance; under shelter he places principal paid on the mortgage, interest on the mortgage, taxes, and repairs; under

all other expenses he includes education, health, allowances, and travel. The accompanying table shows the percentages allowed for each item.

\$285 Monthly Income—Brownell Family

Item	Per cent	Amount	Item	Per cent	Amount
Savings and insurance Food Shelter	20		Clothing	12 10 15	

Complete the table, figuring the amount allowed monthly for each item.

### Part I

# How Goods Are Consumed

Chapter II:

THE CONSUMER AND HIS WANTS

Chapter III:

FACTORS INFLUENCING CONSUMER DEMANDS



Lambert from Frederic Lewis

CONSUMERS—The students above are demonstrating their role as consumers in satisfying a desire for an after-class coke. What other goods besides food do they consume?

## Chapter 11

## The Consumer and His Wants

### Aims of This Chapter:

To define consumption.

To learn why consumption is important.

To examine the characteristics of human wants.

To explain and classify goods.

To find out what goods must possess to satisfy wants.

Now that you have been introduced to the subject of economics and have an idea of the problems with which it deals, you are ready to consider the first of these problems—the wise use or consumption of goods.

What Is Consumption? If you make a few observations in your home, you will see that everyone in the family is engaged in certain activities. You will see that the family as a whole as well as the individual members are using things. Food is eaten three times a day, clothes are worn by members of the family, fuel is burned in the furnace to keep the house warm, gas is burned to cook food, furniture is becoming shabby through use by the family, rugs are worn out and discarded, gasoline and oil are burned to operate the family automobile, the telephone is used frequently, a doctor is called in from time to time to attend some member of the family. In other words, you find that your family uses many commodities and services every day. These economic goods are used in order to satisfy the wants of the members of the family.

Why are these commodities and services wanted? Naturally, they are wanted because they are useful. If the goods were not useful your family would not have paid good money for them. Although it is food, fuel, clothes, gasoline, and other actual goods that are used up, it is the utility in them that causes them to be wanted and used. We

may, then, define consumption as follows: Consumption is using up whatever usability or utility there is in goods in order to satisfy our wants.

Why Is Consumption Important?—The human infant is a consumer from the moment of his birth. From birth until death people continue to consume goods. Some people consume more goods than others; some people consume goods in one way and some in another. The way in which we use goods as well as the kind of goods we use determines the plane of living we maintain. As soon as a community finds that it must cease using the type and quantity of goods to which it has been accustomed and must use cheaper and fewer goods, something happens. Those who produce the goods formerly required cease to make so many of these goods. This means that fewer workers are needed and unemployment occurs. Less money is now available to spend for goods and thus other producers are affected. Those who used the former type of goods now must use cheaper goods, and this means that they must live on a lower plane. Thus you see that unless consumption continues, goods cannot continue to be produced. Consumption and production are closely related. In fact, consumption controls production to a large degree because goods will not be produced unless there are consumers to buy them.

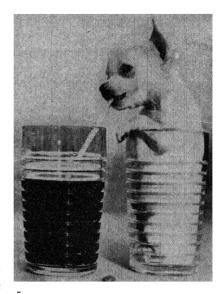
Who Are Consumers?—We have used the word "consumer" several times, but we have not explained who consumers are. In a general sense we are all consumers because we all use commodities and services of some kind. Your father and mother are consumers because they buy and use food, clothing, and other articles for themselves and the family. All the other members of your family are consumers for the same reason. You are a consumer at school when you eat your lunch or use pen and ink in writing your themes.

But people buy some goods because they intend to use them to satisfy the wants of others. A man who owns and conducts a retail clothing store buys clothing not for his own use but to satisfy the wants of his customers. A manufacturer buys materials with which to produce other goods which will satisfy the wants of other people. The maker of soap cannot use all his product for his own purposes. He makes it to satisfy others who want soap. When people do such things, they are producers rather than consumers. For our purposes we shall define consumers as those who use up commodities and services for the direct satisfaction of their wants.

How Are Wants Classified? You are now ready to learn

something about wants. It has been pointed out that the primary reason why people work is to satisfy their wants. Human beings have wants for a great variety of things, but these wants may be classified into two large groups: (1) wants for necessities and (2) wants for things other than necessities. Wants for necessities, such as food, clothing, and shelter, are called primary or existence wants. They are wants for the things that we must have if we are to sustain life and carry on our daily activities.

No normal human being today is content merely to satisfy his primary wants. He desires to



Acres: Photo

SMALL-SCALE CONSUMPTION-Above is a small consumer. Rhodes Tiny Ioe, an aristocratic Chihuahua pup, is transferring one pint to another.

improve his living conditions, his social standing, and his economic position. To accomplish this he wants better food and more of it, more and better household furnishings, more education and training for himself and his children, an automobile, laborsaving devices in the home, some recreation, and an opportunity to travel and see the world. In fact he desires a higher standard of living. Wants for the things that improve the standard of living and make life more enjoyable are known as secondary or cultural wants. A large part of our time and energy is spent in satisfying this type of want.

What Are the Characteristics of Wants?—Both primary and secondary wants have certain characteristics which make them important to us and to those who supply us with commodities and services. What are some of these characteristics?

There Is No Limit to Our Wants.—This statement needs little explanation. From infancy to old age, human beings are constantly wanting something. Many of these wants are never satisfied. As children you wanted nearly everything you saw. Now that you are older, you have no fewer wants even though they may be for things

that you did not want years ago. Older people are much the same. They, too, are constantly wanting things. The only limit to our wants seems to be a lack of more things to want.

Our Wants Are Never Completely Satisfied.—The important word in this statement is "completely." It is possible to satisfy a want for some particular thing for the time being, but sooner or later the want for that thing will return or a want for something else will take its place. You arise from the dinner table satisfied, but in a few hours you have a want for food again. Mark Twain is reported to have said, "The only satisfied man is in the cemetery." This is just another way of saying that a normal human being always has unsatisfied wants.

One Want Leads to Another.—This characteristic of wants has been used by producers and retailers. When your parents decide to redecorate a room in the house, they soon find that painting the woodwork and papering the walls are not enough. To make the room look well it is necessary to do something to the floors and the ceiling. Then the electric fixtures must be modernized, and so it goes. When the furniture is moved in, it looks shabby and so new furniture is wanted or the old furniture has to be reconditioned. Thus what seemed a simple want at first requires several others to be satisfied before enjoyment is complete. Those who produce and sell goods are aware of this peculiarity of wants; that is one reason why they advertise accessories to many articles.

Wants Compete with One Another.—You have probably come in contact with this characteristic more than once. When you started out to buy a new suit or a new coat, you probably intended to buy a particular style and color. However, after you entered the store and began to examine the goods, you soon found your want changing. The salesman showed you some smart clothes in a style and pattern you had never seen and told you how much better you would look in the new style. You finally were convinced and went home with a different suit or coat than the one you had intended to buy. What made you change your mind? It was the competition set up by the newer styled article. Competition between wants takes place just as competition occurs between businessmen.

Why Are Wants Significant?—Why is this matter of wants stressed so much? Everybody has wants and everyone knows they are unlimited. Why say any more about them? A moment's thought will

show you that if people did not have wants or if the wants they have were ever completely satisfied, there would not be much activity in the business world. It is because people want things that someone devises the goods that are wanted. Because wants are ever changing, men invent new things, new processes, new styles, and make improvements in goods. You will be able to think of many things that exist today that were brought into existence because it was felt that they would satisfy the wants of a large number of people.

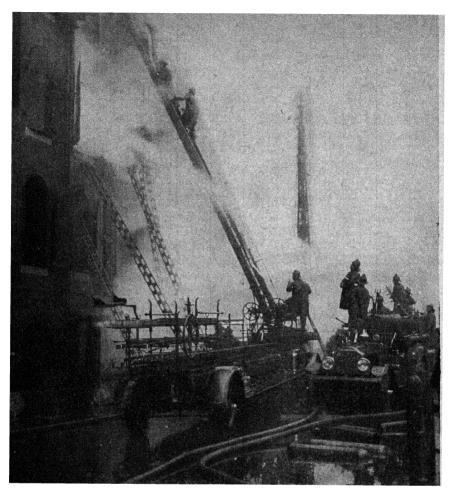
If there were few or no wants, we should have a different world in which to live and work. Wants are the things that make economic progress. It is because people must satisfy their wants that they work. As soon as one want is satisfied, people work harder to satisfy other wants. If production is to continue, if jobs are to exist, if progress is to be made, there must be wants. Thus you see that wants are very important in our economic life.

What Do Consumers Want?—Consumer wants are numerous and varied but they can be classified under two headings: (1) wants for commodities and (2) wants for services. Goods is the term applied to all those commodities and services that satisfy human wants.

Commodities as Goods.—Commodities include houses, furniture, clothing, tools, machines, food, newspapers, flowers, works of art, and countless other articles that people require to satisfy their wants.

Services as Goods.—All the articles just mentioned as commodities are things that can be seen, handled, and passed from person to person. They are called material goods. Man desires many material goods to satisfy his wants. But in addition to material things people also want services which are in no way material. At times the services of a doctor, a lawyer, a minister, or a nurse are needed. In obtaining an education the services of teachers are essential. If government is to be conducted in the interests of the people, honest men must serve as officials. No one will question the fact that these services satisfy wants. Therefore, because services satisfy wants they are called "goods" in economics. This leads to a complete definition of goods: Goods are all material things and nonmaterial services that satisfy our wants.

What Kinds of Goods Do Consumers Desire? We have said that consumers want goods to satisfy their wants, but we have said nothing about the nature of these goods. Some of them exist in great abundance while others are relatively scarce. Some goods last a long



Hirz from Frederic Lewis

SERVICES AS GOODS—What havoc would befall a community without its firemen! In economics we speak of their services as nonmaterial goods. Firemen are salaried government employees in the cities; in many smaller towns the fire department is on a voluntary basis—men join in order to protect their homes and businesses as well as those of their neighbors. When the alarm sounds through the town, the butcher, the baker, the candlestick maker each drops his task to jump on the fire engine as it clangs by.

time while others are used up quickly. There are goods that satisfy our wants directly and goods that satisfy our wants only in an indirect manner. Let us examine the nature of goods more closely.

Free Goods.—Some of the goods we desire and need are not made by man but are supplied by nature. These goods exist in much larger quantities than man-made goods. Air, sunshine, and water are provided by nature in such quantities that anyone can usually obtain all he wants of them without much effort. They are free in the sense that we need not pay for them in order to have them. It is the abundance in which they exist rather than their cost that makes them free goods. Thus free goods are those goods which exist in such abundance that all our wants for them can be easily satisfied.

Economic Goods.—These do not exist in sufficient quantities to satisfy all our wants for them. These goods are usually man-made. Whereas some economic goods exist in large quantities, there are not enough of them to enable all who want them to have them. This means that some effort must be made to obtain them. We must work and earn money with which to purchase them. Economic goods are those goods that do not exist in sufficient quantities to satisfy the wants of all who desire them.

Although nature provides certain things in abundance, it does not always make them convenient to people. It is necessary for man

Levick from Frederic Lewis

FREE GOODS—Here is one of the most valuable of nature's gifts—fish. Perhaps you have never thought of fish as free goods; however, the fisherman pays nothing for them. Fish cost us money because we must pay for the fisherman's labor and equipment and for the services of the middleman who brings them to us.



to make them available in a form or place better suited to satisfy wants. Water is produced by nature in great abundance, but in many localities it would not be convenient to carry drinking water from a brook or spring to the home. You who live in cities or towns merely turn a faucet and get all the water you want, but you or your landlord receives a bill for it from the water company that provided it. Why must we pay for a free gift of nature? It is because nature did not provide it in sufficient quantity in a particular place or in the manner in which it is wanted. Men have to build reservoirs, catch and hold the water, erect purifying plants, lay pipes from the reservoir to our homes, and install machinery to pump it under pressure into our homes. This makes water relatively scarce in the populated centers. and people must pay for the convenience of having it. In this way a free good has been changed into an economic good. Make a list of other free goods that have been changed into economic goods to satisfy wants in a better way than nature has provided.

Durable and Perishable Goods.—Consumers are interested in the length of time goods last. Not all goods give enduring satisfaction. Some goods like fruits, vegetables, candy, gasoline, and perfumes are quickly and completely destroyed in the process of consumption. These are known as perishable goods. Many such goods are desirable and some of them are essential, but consumers purchase them knowing that they will give only temporary satisfaction.

There are other goods, like household furniture, rugs, machines, houses, books, jewelry, pictures, and automobiles, which continue to give satisfaction for a long time if used with care. Goods of this kind can be used over and over again without rapid destruction of their utilities. They are called *durable* goods. The wise consumer wants goods that will be useful for a relatively long time, but bargain hunters purchase cheap goods that look well but fail to wear well. When a consumer purchases such goods, he may be said to have bought perishable goods instead of durable goods.

Consumers' Goods and Producers' Goods.—Goods are also distinguished according to the use that is made of them. Goods that are ready to be used by consumers in the direct satisfaction of their wants are called consumers' goods. Usually these goods are in the hands of the person who intends to use them for his personal satisfaction or they are in such a state of preparedness that they can be made available for consumers on short notice. Thus manufactured goods in factories, warehouses,

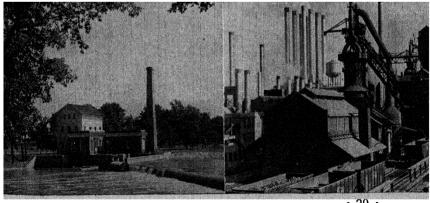


2 1

Courtesy of Ford News Bureau

PRODUCERS' GOODS-Here are four types of producers' goods owned and operated by the Ford Motor Company. (1) In the engineering laboratory new cars are planned and new developments are worked out. (2) The powerful shovel scoops out the earth to make sites for factories and airports. (3) The Dundee water power site develops water power to operate machines in near-by plants and to furnish light and power in the plants and homes. (4) The huge plant is engaged in direct production of goods.

3



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or stores are consumers' goods because they are intended for use by consumers. Many consumers' goods, such as food and fuel, are perishable. Other consumers' goods, such as the oil heater in the home, the family automobile, the refrigerator, the sewing machine, all household furniture, and the house itself, are durable consumers' goods. A very large proportion of all economic goods are consumers' goods.

There are other goods which are useful but which are not intended for the direct and immediate satisfaction of any consumer want. These usually take the form of tools and machines, factory buildings, power sites, and office buildings; they also include raw materials and goods in process. All these goods are essential for the production of consumers' goods. Those goods not intended for the use of consumers directly but used to produce other goods that consumers want are called producers' goods, or capital goods.

Necessities, Comforts, and Luxuries.—The various kinds of goods described above are classified further as necessities, comforts, or luxuries. It is not easy to draw a strict line between these three classifications. The distinction varies from person to person, but perhaps a few words of explanation will serve to give you some idea of the distinction.

Necessities are those things which we must have in order to live and carry on our work. Thus we must have food, clothing, and shelter. But today many other things are considered necessities. A salesman who must travel many miles to sell his goods needs an automobile. Likewise, instruments and special equipment are necessities for surgeons and dentists; law books are essential to lawyers.

Most of you have wants for goods that are not classified as necessities. You want many things that add to the enjoyment of life. These things are so desirable that people are willing to work hard to get them. The piano in your home is not a necessity, but it adds much to your pleasure and perhaps to that of your family. The same may be true of the radio. The automobile your father owns may not be a necessity, but it makes it possible for the family to go places and to visit parts of the country which otherwise it might be impossible to see. These things are called *comforts*.

Not only do people desire necessities and comforts, but they have desires for other things that are more than necessities and even more than comforts. They are known as *luxuries*. They usually include such things as expensive fur coats, diamonds, extra automobiles, country

estates, and yachts. Luxuries are often matters of personal preference and depend upon the income, social position, and taste of the individual.

What Is Wealth?—Practically all economic goods, whether necessities, comforts, or luxuries, can be exchanged for other goods or for money. In economics and in general use these goods are often spoken of as wealth. Economic goods which satisfy human wants and which can be exchanged for other goods are wealth. To be economic wealth these goods should be usable, relatively scarce, material, and transferable. To a businessman wealth would consist of his factory or store, his machinery and equipment, his trucks, raw materials, and finished products. To a working man wealth would be his tools, his clothing, his house and furniture, and perhaps an automobile.

Wealth is called *private* if it is owned by individuals. When cities, towns, states, or the national government owns buildings, parks, waterworks, trucks, fire apparatus, or machinery, it is called *public* wealth.

You will often hear the expression national wealth used. By this term is meant the total of all the material goods of either individuals or groups throughout the nation. Included within this term would be all the homes, all the farms, all the natural resources, all manufactured goods, all products such as wheat and corn, as well as all the power plants throughout the country. The value of wealth, whether it be public or private, is measured in terms of money. The national wealth of the United States is estimated at between 300 and 400 billion dollars. It includes both private and public wealth.

According to our definition of wealth, such things as health, education, personality, and skill are not wealth although they are essential to the accumulation of wealth. They are not material things and cannot be handed over to others. Nevertheless, they are important factors of production or causes of wealth.

Goods Possess Utility.—It has already been stated that a person buys and uses commodities and services because they are usable in some way; that is, they possess some quality that makes them desired. The quality that causes goods to satisfy wants is called utility. Economic goods have many kinds of utility. These are called elementary, form, time, place, and possession utility.

Elementary utility is the quality of usefulness supplied by nature. Coal, for example, gives off heat when burned. Similarly, nature has

supplied the soil with fertility and has given many metals and ores qualities which make them useful to man. If nature had not given qualities of usefulness to many materials, people could not have made of them articles to satisfy their wants.

Form utility is the utility added to a commodity because of the particular shape or form that has been given to it. People take the raw materials furnished by nature and turn them into more useful forms. Iron in the ground possesses elementary utility but, when it has been transformed into a bar or a pipe, it has additional form utility. Any completely manufactured article has form utility.

Time utility is the utility a commodity possesses when it is ready for use at the time it is wanted. Coal in a Pennsylvania mine has no time utility for anyone. But when it is in the cellar in winter, when it is needed, it has time utility. Snowshoes have no time utility in summer, but in winter they possess a great deal of time utility, especially where snow is deep.

Place utility is the utility a commodity possesses when it is where it is wanted. A tire wrench has place utility if it is in your car at the time you are called upon to change a tire. This same wrench has no place utility for you if it is back home in the garage, miles away.

Possession utility is the utility that is added to an article because it is owned by someone. An automobile may have all the utilities thus far described but it lacks utility for you because it is not yours.

Summary.—Consumption is the using up of utilities in goods in order to satisfy our wants. Whenever and wherever goods are used to satisfy a want, consumption takes place. Consumption is important because it is the basis of production. If goods are not consumed, they will not continue to be produced. If goods are not produced, people do not work. Thus a steady consumption of goods is very important if economic activity is to continue.

We are all consumers because we all use commodities and services of some kind. But some are also producers of goods to satisfy human wants. Those who use goods for the *direct* satisfaction of their wants are the actual consumers in the sense in which we shall use the term. The wants of consumers are either primary or secondary. Primary wants are for things necessary to sustain life and to carry on our daily activities. Wants for things that make life more enjoyable and improve our standard of living are secondary or cultural wants.

Human wants have many characteristics that affect our buying habits and our standard of living. The significance of wants lies in the fact that, if we should cease to have wants or if we could satisfy our wants easily, industry would be crippled. Wants are the forces that lead to inventions and improvements in products. They make economic progress possible.

Consumers want commodities and services. Goods are all those material commodities or nonmaterial services that satisfy wants. Thus services are goods in economics because they satisfy wants. These want-satisfying goods are classified as free or economic depending upon their quantity; durable or perishable, depending upon their lasting qualities; consumers' or producers' goods depending upon their use.

All economic goods that are useful, material, relatively scarce, and transferable are called "wealth." This wealth may be owned by private individuals or by public groups. National wealth is the total of all the material goods that satisfy the wants of the people throughout the nation. Such things as health, education, personality, and skill are not wealth because they are not material and cannot be transferred from person to person. Nevertheless, they may be factors in production or causes of wealth.

When consumers purchase commodities and services, they are actually buying utility and must pay for the utility added to the goods. Nature supplies elementary utility, but man adds form, time, place, and possession utility. All these qualities are essential if goods are to satisfy our wants most completely and most conveniently.

### Questions to Test Your Knowledge

- 1. Define consumption.
- 2. Why is consumption so important?
- 3. Distinguish between consumers and producers.
- 4. Distinguish between primary and secondary wants with examples of each.
- 5. Show that wants are never completely satisfied.
- 6. What is meant by saying that wants compete with one another?
- 7. Why are wants considered of so much importance?
- 8. Define goods.
- 9. Why are services considered as goods in economics?

- 10. Distinguish between free goods and economic goods.
- 11. What is the difference between consumers' goods and producers' goods?
- 12. Define wealth.
- 13. Why is education not wealth?
- 14. Define utility.
- 15. What kinds of utility should economic goods possess?

### Questions for Discussion and Application

- 1. Show the relationship between consumption and production. Illustrate your answer with several examples.
- 2. Show by definite examples that where wants are most numerous and varied progress is greater and standards of living are higher.
- 3. What use is made of the characteristics of wants by producers, retailers, and advertisers?
- 4. It has been said that consumption is the final cause of all economic activity. Discuss this statement.
- 5. Discuss the factors that help to determine whether an article is a necessity, a comfort, or a luxury.
- 6. It has been said that all useful things are not necessarily wealth. What have you to say as to the truth or the falsity of this statement?
- 7. If education, health, personality, and skill are essential to the success of individuals and to their ability to earn a living, why are they not wealth?
- 8. Consider the pair of shoes you are now wearing. Make a list of the steps through which these shoes went from raw materials to you. What utilities have you paid for? Who furnished these utilities?
- 9. Discuss the statement that the great problem of American business is one of consumption rather than one of production.

### Floor Talks and Written Reports

- 1. How cultural wants cause economic progress.
- 2. Do consumers control their wants?
- 3. How utility affects what we buy.

### Topic for Debate

RESOLVED, That if people spent their money for comforts rather than for luxuries, standards of living would be higher.

### For Further Information

Anders, E. M., and C. D. Cocanower, "Economics and the Consumer," Chap. 3.

Building America, "We Consumers," Vol. 2, No. 6.

Gaer, Joseph, "Consumers All."

Gordon, L. J., "Economics for Consumers," Chaps. 1, 2, 3.

Hoyt, E. E., "Consumption in Our Society," Chaps. I, XX, XXI.

Jacobson, D. H., "Our Interests as Consumers."

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#### PROBLEM 3

### Those Provoking Wants

It has been said that there are only two ways for a person to become satisfied: One is not to want at all and the other is to get the thing he wants. Whether this is true or not, we do know that wants have always plagued human beings and that we have wants whether we like it or not. But wants have not always been looked upon as blessings. In colonial days people were punished for having certain wants, especially wants for things that gave pleasure. In those days and for some time later, self-denial was a virtue to be practiced regularly.

But times have changed. Except in time of war, it is now considered antisocial to suppress wants. The more wants people try to satisfy, that is, the more they buy, the better it is for business and the more jobs there will be. The progressiveness of nations is judged by the number and kind of wants its people have. Producers and advertisers spend millions of dollars to make people want things. Wants have become a serious problem in many families because the income is not sufficient to satisfy them all and discontent arises.

- 1. Would you consider a person normal who had no wants?
- 2. Do you think that people in colonial times were happy in spite of their restricted wants?
- 3. Have wants increased in number?
- 4. How do you account for the fact that we want so many things today?
- 5. Do people today control all their wants or are some of these wants stimulated by outside agencies?
- 6. Why are wants necessary if industry is to flourish and jobs are to be available?

### PROBLEM 4

### Spending the Family Income

The Brownells must satisfy their wants out of their income. These wants are for necessities, comforts, and luxuries. Among the necessities are food, clothing, shelter, fuel, services of doctors, dentists, and oculists. Mrs. Brownell is responsible for spending the family income in such a way that as many of these wants as possible may be satisfied. Upon her judgment in buying depends the welfare of the entire family. She has allowed herself \$57 a month to provide food for four persons (see Problem 2). This does not permit foolish spending.

She knows that when she buys foods that are in season, she obtains better food values. She must often choose between fresh or dried fruits and canned fruits. She has learned that the cheaper cuts of meat often have as much food value as the more expensive ones. To be a wise buyer, to get full value for her money, requires much planning and careful money management. She has also learned about vitamins and uses this information when she purchases food. But she wonders how her parents got along and lived to such ripe old age without this knowledge.

Mrs. Brownell is impressed with the fact that her family does not consume so much food as her mother's family did, but that they require a greater variety of foods. Thus she must give heed to the quantity of each article she buys in order that there may be no waste. She is also aware that she has to pay more for the food she buys than her mother did.

In addition to buying food for the family, Mrs. Brownell has to purchase the clothing for the family. She has allowed herself \$34.20 a month for this purpose. With four people to clothe, this does not permit extravagance or careless buying. Therefore, she seeks clothing that has utility, style, and comfort. She is especially desirous to buy clothing that will wear long and keep looking well. Here again she must choose between things needed and things that merely satisfy a whim.

- 1. What is money management?
- 2. Did Mrs. Brownell's parents obtain vitamins although they did not know of them as such? Explain.
- 3. Is it a fact that we require less food today than was required by our grandparents? If so, how do you account for this fact?
- 4. What causes most foods to cost more today than they did fifty years ago?
- 5. Have our buying habits changed in the past fifty years?
- 6. What things does Mrs. Brownell have to consider that her grandparents did not need to consider?

## Chapter III

# Factors Influencing Consumer Demands

### Aims of This Chapter:

To distinguish between desire and demand.

To learn what determines the kind of goods consumers demand.

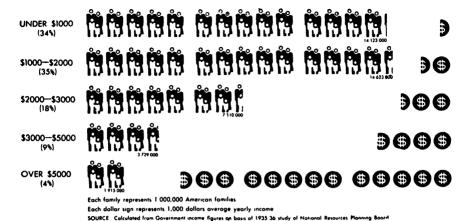
To discuss the tendencies followed by consumers in buying.

To observe how diminishing utility affects wants.

To find out how consumers use goods.

In the preceding chapter you learned that consumer wants are numerous and various. It will now be your task to examine some of the factors that influence consumers in buying goods. Before doing so, however, you will need to learn the difference between a desire and a demand.

Are Desire and Demand the Same?—Desires are longings for things you see or hear about. All of you have many desires, but if you continued merely to desire things and never made an effort to satisfy your desires, there would be very little economic activity. There must be something more than desires if you are to enjoy consumption and to achieve production. What is needed is to make these desires effective by purchasing the thing desired. As soon as you express your desire with a willingness to buy the article desired, a demand is created. For example, suppose you have a desire for a fountain pen. If you spend time looking in the window of the store where the pens are displayed and merely experiencing a wish for a pen, the merchant will never sell you one. But if you enter the store, select the pen and pay for it, you have created a demand. Demand is the desire for an article accompanied by the ability and willingness to pay for it.



The standard of living is largely determined by income. How many of these families could enjoy a good standard of living?

What Determines the Kind of Goods Consumers Demand?—Consumers are seldom able to satisfy all their demands for goods or even a small part of them. Many consumers would like to satisfy their demands for goods, but they find their ability to do so restricted by certain factors. What are some of these factors?

Differences in Incomes Affect Consumer Spending and Standards.—The most influential factor in the consumer's choice of goods is his income. Very few people have an income so large that they can choose goods to satisfy their wants without considerable thought. If the most urgent wants are to be satisfied and anything is to be left for other things, most consumers must plan their spending with the greatest care. A consumer who earns only enough to supply himself and family with necessities has little choice in his spending. Such a consumer cannot create many demands. But a consumer who earns a large amount of money is able to satisfy his needs and still have enough left to satisfy demands for other goods.

The amount of income received and the way it is spent determine a consumer's standard of living. By standard of living is meant the amount and kinds of goods one is accustomed to consume. It is the scale upon which one lives. One's standard of living determines not only the kind of goods normally demanded but sometimes what will not be demanded. All consumers do not enjoy the same standard of living.

Some live on a poverty level; some on a comfort level; and still others on a luxury level. But whatever the level, it has an important and deciding effect upon the kind of goods consumers will demand. Those who are on a low standard of living choose mostly necessities or at least only cheap goods. As the standard of living rises, more and better goods are bought and an effort is made to raise still higher the standard.

The National Resources Committee made a study of consumer incomes in the United States for 1935–1936. This committee found that 14 per cent of all families received less than \$500 a year income; that 34 per cent received less than \$1,000 a year; that 69 per cent received less than \$2,000 a year. Only 4 per cent of all families had incomes over \$5,000; and only 1 per cent received over \$10,000 a year. If the size of the family income determines the amount and type of goods the family can buy, it is not hard to believe that income is the vital factor influencing consumer choice of goods.

How Are Consumer Buying Habits Influenced?—Although income is a vital factor in consumer buying, there are other factors which assume prominence.

Custom and Tradition.—From earliest times consumer demands have been influenced by custom. Customs are handed down to us by our parents and grandparents. Many of the articles we use today were also used by our parents and grandparents. Custom has been a deciding factor in matters of food, dress, house furnishings, types of homes, manner of living, sending of cards at Christmas, on birthdays, on anniversaries, etc. Some customs have arisen in more recent times. For example, a wrist watch is now the customary thing to wear instead of a watch that hangs from a clasp, fob, or chain. You can probably name several things you use because it is the custom to do so.

Occupation.—The type of work in which a consumer is engaged has much to do with the kind of goods he will demand. A day laborer demands a type of food different from that of a lawyer. A man whose work keeps him outdoors in all sorts of weather needs clothing different from that of the man who is indoors most of the time. The policeman or the fireman needs things that are not needed by the teacher or the bank clerk. The professional man or woman needs books, while the salesman demands an automobile. Examples could be multiplied, but these will suffice to show you that a consumer's choices are affected by the occupation in which he is engaged.

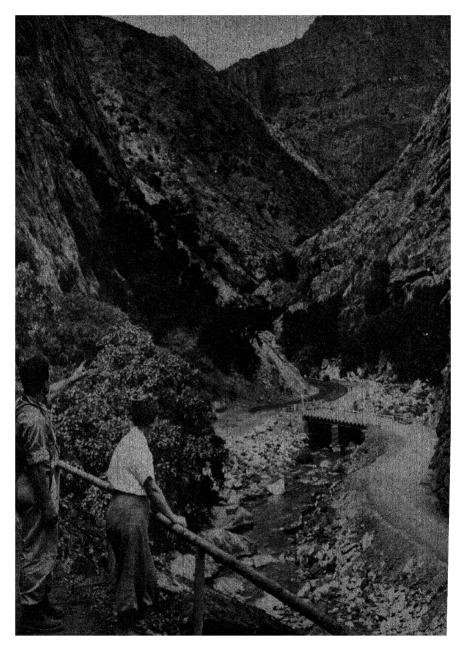
All of us belong to social groups and have contacts with other groups while at work. The type of clothing we wear, the kind of houses in which we live, the type of recreation we enjoy, and even the kind of food we eat, are the results, to a large extent, of the influence of the groups to which we belong. Wherever we find a group whose income and tastes are similar, we find that there is also a great similarity in the types and quantities of goods demanded.

Style and Fashion.—The influence of style and fashion upon consumer demands is almost as powerful as that of custom and occupation. As soon as a new fashion in dress or a different manner of furnishing houses appears, there are many consumers ready to adopt it. This is shown clearly in the case of automobiles. When the latest model appears with its new gadgets and accessories, sales at once increase because so many buyers are influenced by the desire to follow the fashion and be in style. Fashion influences choices in another way. Persons often adopt a new fashion because they do not wish to appear behind the times or unable to have the new things. Many a woman purchases a new hat to satisfy this type of want.

Education and Travel.—These are considered powerful influences affecting consumer demands. The more we learn about people and places, the more we hear and see, the more we want. Education has a way of making us see how inadequate are many things to which we have been accustomed; it creates desires for new things. Sometimes it makes us appreciate the old, as when we want to buy a piece of antique furniture. Travel is no less influential than education itself. When automobiles made it possible for us to visit new places, to observe what others have, and to learn about things we did not know existed, our desire for these things was stimulated.

Advertising and Salesmanship.—These are among the most direct and insistent factors stimulating wants. Millions of dollars are spent each year in an effort to persuade people to purchase goods. Good advertising tells us about articles that are new and useful and tells it in such a way that it is difficult to resist the appeals. No doubt you can name several articles used in your home that were bought because your parents heard of them through advertising.

Salesmanship accomplishes the same result as advertising. But there is a difference in the approach. Advertising is usually impersonal and is addressed to all who read or listen. Salesmanship is a



Muench from Frederic Lewis

TRAVEL—Here is a scene in California's Kings Canyon National Park. Those who visit this region for the first time learn the story of the valley and enjoy the beautiful scenery. The automobile road makes it possible to drive far into the valley.

personal appeal made directly to the person to be influenced. Both advertising and salesmanship have exerted much influence upon consumers and have been very effective in helping them to decide what to buy. Often the things advertised and sold are useful, but sometimes they are not.

What Tendencies Do Consumers Follow in Buying?—You have learned about the various factors which influence consumers when they demand goods and which determine the quantity and type of goods bought. These relate mostly to the satisfaction of certain definite wants. But there is another side to the problem of how consumers satisfy their wants. This relates to the tendencies followed by consumers to such an extent that they have become known as "laws of consumption." Let us see what they are.

Tendency to Desire Variety in Goods.—You do not get much satisfaction from consuming the same article all the time. You do not want oatmeal and toast for breakfast every morning. You find it much more satisfactory if there is a change from time to time or if there is a variety from which to choose. "Variety is the spice of life" is as true today as it ever was. Why do we have clothing of different colors, patterns, and styles? It is because we get more satisfaction from a variety than from just one color, pattern, or style. Greater satisfaction is obtained from the consumption of a variety of goods than from consuming the same good all the time. This is known as the law of variety.

Tendency to Imitate Others.—In spite of our claims to independence in the choice of things we buy, we are all more or less influenced by a desire to do as others do. We tend to want for ourselves the things we see our neighbors and influential people have. When we are told that some noted screen star or athlete uses a certain cosmetic or soap, we too may want that article. This tendency to imitate can be seen in the books we read (best sellers), in the amusements we attend, and in the type of car we buy. People tend to imitate others in the kind of goods they consume. This is the law of imitation.

Tendency to Desire Harmony in Goods.—In the serving of a course dinner there is a reason for the order in which the various courses are eaten. Would you enjoy a dinner if you ate the dessert first, then the meat course, and followed this with the soup and the salad? Of course not. The courses are so arranged that the greatest satisfaction will be derived from each. You do not paint the woodwork of your

room a color that clashes with the wallpaper, nor do you wear a necktie or a scarf that does not match your suit or dress. Why do you want a handbag that matches your dress? It is because you desire harmony and get more satisfaction when things do harmonize. Greater satisfaction is obtained when want-satisfying goods are consumed in the proper combination. This is the law of harmony.

Tendency to Satisfy Essential Wants First.—Because our incomes are not large enough to permit us to satisfy all our wants, we are obliged to consider carefully how we shall spend our money. We try to spend it in such a way that we get the most for it. If you had \$10 to spend, you would buy first what you needed most, perhaps a dinner or a pair of shoes; then you might buy some article of clothing such as a hat or gloves; if there was anything left, you might spend it for something that gave you pleasure, such as flowers, candy, fruit, a theater ticket, etc. People tend to choose their goods in the order of their greatest utility. This is known as the law of economic choice.

What Is Engel's Law of Family Expenditures?—A study of how families spend their incomes was made long ago by a Prussian economist named Engel. The principles he derived then in Germany have proved true even today in America. Engel's law may be stated as follows:

- 1. As the family income increases, the *percentage* of income spent for food decreases, although the actual amount increases.
- 2. The *percentage* spent for clothing varies little with the increase in income, even though the actual amount spent varies greatly with the size of income.
- 3. The *percentage*, not the actual amount, of income spent for rent, fuel, and light remains about the same despite changes or differences in income.
- 4. As the income increases, the *percentage* spent for the better things of life, such as education, recreation, health, and personal services, increases even more markedly than the actual money expenditure increases.

Many studies have been made in the United States, using certain cities as the basis for study. In nearly every case it was disclosed that Engel's conclusions held good. The only place where variations were found was in the matter of household furnishings and expenditures on the home. These were found to be greater in the cities studied than in the cases Engel cited.







Frank Gawel

This boy is overjoyed at the prospect of eating all the hot dogs in sight. But before he has consumed many, he begins to feel rather uneasy. He cannot eat as many as he thought he could. What economic law is illustrated here?

How Does Diminishing Utility Affect Our Wants?—In the discussion of the characteristics of wants it was said that it is possible to satisfy a single want temporarily. But you know that you get little or no satisfaction from consuming a large number of units of the same good at about the same time. You want variety of goods or an interval of time between the same goods.

This can be illustrated by an example familiar to all of you. Most young people like hamburg sandwiches. When you go on an outdoor picnic and smell the hamburgs cooking, your appetite is keen and you feel that you could eat an unlimited number of these sandwiches. The first one you eat does taste extremely good and is eaten with great enjoyment. A second tastes almost as good as the first and is eaten willingly. A third is eaten more slowly and does not taste so good as the earlier ones. A fourth may have to be forced down; perhaps it tastes "smoky." It would be almost impossible to get you to eat a fifth. Why? Because you have learned that the enjoyment derived from eating hamburgs one after another grows less as you consume each one.

It should be pointed out that you would not have noticed this diminishing satisfaction so much had you been permitted to take a rest or some exercise after eating each sandwich. This tendency of the same good to give less and less satisfaction as you consume additional portions without interruption is known as the *law of diminishing utility*. A simple statement of the law is: the satisfaction derived from the con-

sumption of any good tends to diminish as one consumes or acquires successive units of it.

The law of diminishing utility applies to all kinds of goods and not just to food, as the example may have led you to infer. It means that there is a limit to the number of units of any given good that a consumer can use to advantage or can even use at all within a limited period of time.

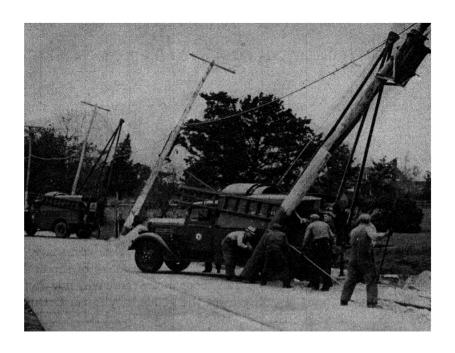
The utility of the last unit consumed or acquired, called the marginal unit, is the *marginal utility* of the commodity. As we shall see later, it helps to express the value of a commodity. By margin is meant a border line or place of measurement. By marginal is meant last or least. These terms are in frequent use and of great importance in the study of economics.

How Do Consumers Use Goods?—After the consumer has obtained the goods he wants, what use does he make of them? You know that all consumers do not use goods in the same way nor do they get the same amount of utility from the goods they have. Let us see how they use their goods.

Most Consumers Use Goods Directly.—Most goods are used by consumers to satisfy their own individual wants. When a person eats food, burns gasoline in his automobile or fuel oil in his furnace, or wears clothing, he is making a direct use of these goods. This kind of consumption is called direct. Sometimes the term final is used because the act of consuming destroys the goods.

Some Consumers Use Goods Indirectly.—All goods are not used for the direct satisfaction of personal wants. A cabinetmaker uses boards and nails to make a desk or a bookcase. But these articles are not for his own use. He has used the goods in order to produce something to satisfy the wants of others. This kind of consumption is called *indirect* or *productive* consumption.

Some Use Goods in a Harmful Manner.—Unfortunately, all consumers do not use goods in the most efficient way. Some use them in such a way that they injure themselves physically, mentally, and morally. When a person eats food that is not good for him, he develops indigestion which may in time become serious. When you eat an excessive amount of sweets, you may cause your teeth to decay and be put to expense and discomfort before the damage is remedied. When a person uses stimulants or drugs to excess, he reduces his



Courtesy of American Telephone & Telegraph Co.

WASTEFUL CONSUMPTION—Here is a New England scene right after a recent hurricane had wrecked the telephone poles and lines for many miles. Economic waste of this kind is costly but difficult to prevent.

efficiency and makes himself undesirable to others. These are all examples of *harmful* consumption of goods.

Some Consumers Waste Goods.—Waste of goods takes many forms. When you order two large pieces of rich chocolate cake for dessert and find you cannot eat both, you throw part away. You have wasted food. When food is bought in quantities too large for the family to eat at one time and some of it has to be thrown away because it spoils, we have another example of waste. During a milk strike large quantities of milk were poured into the gutters. This is another form of waste. In all these cases goods were destroyed, but no want was satisfied thereby. This is sometimes called wasteful consumption.

Wasteful consumption occurs in still another form when earthquakes, hurricanes, floods, dust storms, droughts, fires, and wars destroy goods. A drought dries up crops and causes suffering for men and animals. A dust storm ruins what was once fertile land and prevents its use for further production of crops. Earthquakes, hurricanes, and floods are usually beyond the control of man, but fires and wars might be prevented. You are well aware of the destruction of wealth that resulted from the last war—this is an extreme case of waste.

Some Consumers Use Goods to Show Off.—There are people who like to display their wealth before others for the sake of the prominence it gives them. Some build palatial homes furnished with the finest rugs and paintings in order to be envied or admired. Some wear expensive jewelry when they appear in public in order to attract attention. But the conspicuous use of goods is not limited to the rich. Many people of modest means like to live on a scale which is beyond their income in order to make others think them well to do. Putting on a "false front" and other flashy forms of consumption give little satisfaction compared with their cost. A noted economist, Veblen, calls them conspicuous consumption.

Summary.—Consumers have desires and demands. Of these, desires are the most numerous, but they are of no economic importance unless they are made effective. That is to say, unless consumers have the ability and willingness to purchase the things they desire, there will be no demands.

In their efforts to make their desires effective, consumers are influenced by many factors. Chief among these factors are income, standard of living, custom, occupation, social and group demands, education, style, advertising, and salesmanship. All these exert a tremendous influence upon the quality and quantity of goods consumers demand. Furthermore, consumers buy goods in accordance with certain tendencies which are so general that they are known as laws of consumption. These are the tendencies to desire variety in goods, to imitate others, to have goods that harmonize, and to satisfy essential wants first.

Consumers know that it is impossible to satisfy all their wants completely and permanently, but that a single want can be satisfied temporarily. They also know that they do not get the most enjoyment from the consumption of a large number of units of the same good at the same time. This is because of the law of diminishing utility which says that the satisfaction derived from the consumption of a good tends to diminish as we consume or acquire successive units of it.

After the consumer has exercised his choice and has obtained the goods he wants, he does not always make the best use of the goods.

Nor do all consumer use goods in the same way. Most consumers use goods in order to satisfy their own personal wants. This is a direct use of goods. Others use goods in order to make them available to others but have no intention of using the goods themselves. This is an indirect or productive use of goods. Still others use goods in a manner that harms rather than benefits them. Too many consumers use goods wastefully and thus fail to get the satisfaction from them they should. Nature also indulges in wasteful consumption when it destroys goods through earthquakes, hurricanes, floods, droughts, and dust storms. Fires and wars account for the loss of valuable goods. Finally, there is a group who like to use goods for the purpose of showing off their wealth, of attracting attention, and of gaining recognition.

### Questions to Test Your Knowledge

- 1. Distinguish between desire and demand.
- 2. Why is this distinction important?
- 3. Why is income considered the most influential factor in deciding what consumers will demand?
- 4. What is meant by a standard of living?
- 5. How does one's standard of living affect his demands?
- 6. Show by several examples that one's occupation influences the type of goods he purchases.
- 7. List several articles used in your home that were purchased because of advertising or salesmanship.
- 8. State the law of variety and give an example from your own experience.
- 9. When you buy a handbag to match your dress or a necktie to match your shirt or suit, what law of consumption are you obeying?
- 10. Do you obey the law of economic choice when you purchase your lunch at school? Explain.
- 11. State Engel's law.
- 12. State the law of diminishing utility.
- 13. What is the distinction to be drawn between the direct and the indirect consumption of goods?

### Questions for Discussion and Application

1. Discuss and evaluate the various factors that affect consumer demands.

- 2. Fashion is said to be a powerful influence in consumer choices. Does the consumer decide the fashion? Or does the producer decide them?
- 3. The study of consumer incomes by the National Resources Committee showed that there is a great inequality of income. Do you think this inequality is justified? What might account for the inequalities?
- 4. To what extent are you free to choose the goods you want? What factors act as a restraint upon your freedom of choice?
- 5. To what extent does fashion determine your choice of clothing? your choice of food? your choice of the books you read?
- 6. Explain the effect upon your buying habits if you were not at all interested in what your friends had.
- 7. What consumer purposes are served by advertising?
- 8. Show that the law of diminishing utility applies to all economic goods. State the law and explain the conditions under which it is true.
- 9. Compare the findings of Engel in Germany with various studies made in the United States. Where do you find differences? Are these differences so great that you would say the law does not operate here? Discuss.

### Floor Talks and Written Reports

- 1. Origin of human wants.
- 2. Effects of waste upon society.
- 3. Influences affecting our reading habits.
- 4. Influence of sports on clothing.

### Topic for Debate

RESOLVED, That in the interest of better living for all, the consumption of economic goods should be regulated by law.

### For Further Information

Building America, "We Consumers."

Chase, Stuart, "The Tragedy of Waste."

Chase, S., and F. J. Schlink, "Your Money's Worth."

Hoyt, E. E., "Consumption in Our Society."

McConnell, D., and Others, "Economic Behavior," Vol. II, Book IV.

Public Affairs Pamphlet, "How We Spend Our Money," No. 18; "Income and Economic Progress," No. 1; "More for Your Money," No. 63.

#### PROBLEM 5

### Economic Principles in Daily Life

Let us use again the illustration of Mr. Brownell who operates a garage and filling station in a small city. In the conduct of his business Mr. Brownell buys automobile parts and gasoline from wholesalers and uses them to satisfy the needs of his customers. The nature of his work requires that he often use his skill in fashioning new parts from scrap material and in addition he earns extra money by renewing discarded batteries. Some of the gasoline and oil as well as automobile parts are used from time to time in his own car.

His son works in a local store where his task is quite hard. Before leaving for work each morning, he satisfies a raging appetite by eating fried eggs. After he has eaten two eggs he begins to feel filled up and often leaves part of the third egg on his plate because he does not want to eat it. His mother has told him many times that he would enjoy his breakfast more if he ate some griddle cakes or sausage instead of always eggs. Lately he has tried this and finds she is right. The daughter is still in high school where she is quite popular because of the tasty clothes she wears. The son prefers to dress in the latest styles too, but he buys "flashy" articles. Mr. Brownell is proud of the manner in which his wife manages the family finances because she always pays the bills promptly, buys what the family needs before spending money for other things, and still has something left for emergencies and for little family pleasures.

The above account contains illustrations of the principles you have studied in this chapter. See if you can find examples of (1) productive consumption; (2) direct consumption, (3) conspicuous consumption, (4) law of diminishing utility, (5) law of variety, (6) law of harmony, (7) law of economic choice.

### Part II

## How Goods Are Provided

Chapter IV:

CHARACTERISTICS OF MODERN PRODUCTION

Chapter V:

NATURE'S PART IN PRODUCTION

Chapter VI:

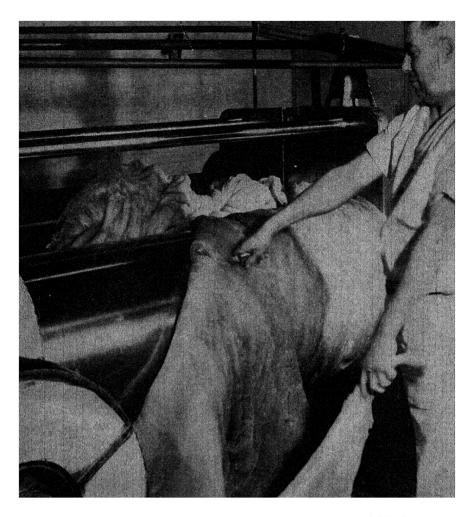
HOW MAN CONTRIBUTES TO PRODUCTION

Chapter VII:

CAPITAL AND HOW IT FUNCTIONS

Chapter VIII:

HOW BUSINESS IS ORGANIZED FOR PRODUCTION





Courtesy of Celanese Celluloid Corporation

MODERN PRODUCTION—The upper picture shows a workman rolling a new plastic product, called Lumarith, one of the toughest of nonmetallic substances known.

The complete telephone set shown at the left is made of Lumarith. The surface of Lumarith is mar-resistant. The more the set is used the brighter the polish on it becomes. Lumarith is also an extremely light material, so this telephone set can easily be carried about.

Here we have an excellent illustration of the relation of consumer goods to producer goods. Man takes the products of nature—in this case mainly cotton—and manufacturers them into goods that can be used by consumers. Lumarith is only one of many types of plastic now on the market.

## Chapter IV

# Characteristics of Modern Production

### Aims of This Chapter:

To define production.

To show how production is related to consumption.

To examine the factors needed to carry on production.

To discuss the characteristics of modern production.

In the preceding unit you learned what consumption is and why it is so important in our economic life. You also learned some of the characteristics of wants and what consumers demand to satisfy these wants, namely commodities and services. The problem to which you will now give your attention is the bringing into existence of the goods which satisfy consumer wants. Where do these goods come from? They do not exist in nature in the form the consumer wishes. Something must be done to nature's gifts to make them more useful. In other words, they must be produced. In this unit you will learn what production means, how it is carried on, and how it is possible for the consumer to have so many things from which to choose. This problem of production has as much interest for the consumer as the problem of satisfying his wants.

What Is Production?—Man does not actually create goods. The materials can be created only by nature. Man takes the materials that nature furnishes and changes them into a form more useful to him. In other words, production creates desirable qualities, known as "utilities." This is not always a simple task because man must make many changes before the goods are useful for various purposes. For example, land must be cultivated, seeds must be planted, cropsmust be harvested, before man can have food; iron ore must be dug from the earth and fashioned into tools before man can do his work

efficiently; trees must be cut down, sawed into boards, and made into houses and furniture; coal must be mined and burned to furnish heat and power. Many other natural resources must be used before they can serve to satisfy man's wants.

As we have said in Part I, man must make many changes in natural resources before they are ready for his uses. Sometimes he makes changes in form as when he changes a tree into boards and the boards into a piece of furniture or a box. Sometimes he makes a change in place as when he transports the boards from Oregon to New Jersey, or cotton from the South to the mills in New England. At other times the changes involve time as when he stores the boards until they are needed or when he stores wheat in a granary until millers and bakers need it. All these changes make the goods more useful to consumers. They are all a part of the process of production because it is not the actual goods themselves that satisfy wants but the utility existing in them. This utility comes from the fact that the goods are in a certain form, in a particular place, or ready when wanted. Thus it may be said that production is the process that creates utilities in goods.

What Relation Exists between Production and Consumption?—Consumption is the process of using up or destroying the utilities in goods in order to satisfy our wants. Production, on the other hand, is the process of adding utilities to goods to make them more useful. This means that consumption and production are opposites. However, they are both essential if people are to live and work. There could be no consumption if no goods were produced. Likewise, if no goods were consumed, there would be no production. This comparison will help you to see why consumers should be interested in the process of production.

What Is Needed to Carry On Production?—We have said that man does not actually create goods but uses nature's gifts and shapes them to his desires. However, he cannot do this alone and still have all the things he enjoys today. He must have the cooperation of many factors. It is usual to list five factors necessary for the efficient operation of production. These are natural resources, or the gifts of nature; labor, man's efforts; capital, or producers' goods; management, or enterprise; and government, or the state. Each of these factors is needed in production today and deserves a more detailed discussion than can be given in this chapter. Here we shall merely outline the factors in a general way, leaving to following chapters a fuller treatment of each.



Wide World Photos

NATURAL RESOURCES—Lumber is one of the most essential of our natural resources. In this New England scene, log drivers with pike poles are breaking up a jam of logs that are being floated forty-five miles down a Maine river to the mill at its mouth. During the winter lumberjacks cut the timber and roll it onto the frozen surfaces of inland lakes or drag it to the river's edge. When the ice goes out in the spring, the water is released from dams at the lakes and the river level rises four feet above normal. Then the log drivers begin their hazardous task of working the tossing, rolling logs downstream.

Natural Resources.—This term is applied to nature's part in the process of production. It is a very inclusive term and comprises things that are familiar to all. It means land or earth from which we obtain much of our food and upon which we build our houses and factories; minerals in the earth, such as coal, iron, silver, copper, and others, which make it possible to have heat and power as well as tools and machines; trees in the forest from which we obtain lumber for our houses and furniture; water power, which supplies us with a very essential product; fertility in the soil; and even sunshine and climate. Any gift of nature which is used to provide for our wants is a natural resource. Because it is the original source of everything, it is called a primary factor of production.

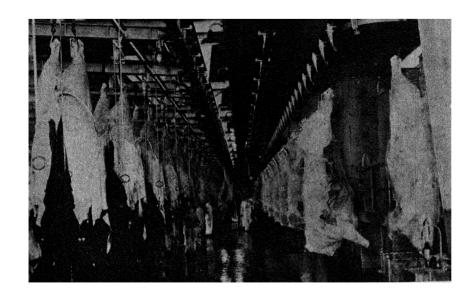
Labor.—This term applies to man's part in the process of providing commodities and services. It is the physical or mental effort of man to make the goods he needs. Because nature's goods, although abundant, are seldom in a form suitable to satisfy wants directly, some change

must be made in them and this is where man enters the picture. Since there could be no production of useful goods without labor, it too is a *primary* factor of production.

Capital. -In primitive times man provided himself with what he needed directly from nature and with the aid of his own hands. He used things almost as he found them in nature and made very little change in the resources nature gave him. This would not be possible today. Modern man has many needs which did not exist in primitive times. To satisfy his wants today man must have tools and machines, trucks, tractors, and many other things which last a long time and which can be used over and over again. Thus capital is any product of past labor that can be used to make other products. It is a secondary factor of production because it does not exist until man has taken natural resources and added utilities to them.

Management.—Sometimes this factor is called "business enterprise." It is the factor that organizes, coordinates, and manages the productive process so that the proper kind and amount of goods may be produced. It is a much-needed factor today and is, in a sense, the brains of the entire process. It performs the tasks of organizing business, obtaining capital funds, assembling materials and labor, building factories, assuming risks, and directing the enterprise after it is established. It is a secondary factor.

Government.—Primitive man did not need an organization to make laws as to how he should do his work or obtain his needs. He made his own rules and regulations. Modern production, however, is a very complicated process and, because it is so essential to our existence, it must be conducted efficiently and in the interests of all. There must be rules for playing the game in order to protect producers, consumers, and workers. There must be some authority to establish weights and measures, to see that agreements are kept, to protect workers against exploitation, and to see that people are not cheated by poor goods and bad practices. Goods made in one place are often sold all over the country. Someone must determine how this shall be done for the benefit of all concerned. Unfair business policies must be prevented, and monopolies must not be permitted to take advantage of the public. The only agency that can do these things for all is the government. This explains why government has become an increasingly important factor in the process of production. During the Second



Armour and Company

LOCALIZED INDUSTRY—Many important meat-packing companies are located in Chicago. Here you can see the immense processing line in Armour's Chicago beef house, one of the largest in the world.

World War government assumed control of practically all production and gave an excellent example of the manner in which governments can function in production.

What Are the Characteristics of Modern Production?—Compared with the present methods of production, the process used a hundred years ago was very simple. Then factories were small, usually owned by an individual or a family, not much machinery was used, handwork was quite prevalent in many factories, capital funds were small, and there was practically no division of labor. Today all this has changed. Modern production has certain distinctive characteristics. In this chapter we shall outline them briefly and devote more discussion to them in later chapters. The purpose of this chapter is merely to give you a broad picture of the process of production.

Industry Is Localized.—This means that certain types of industries have tended to concentrate in certain localities. A few examples will show you the truth of this statement. A very large proportion of all the automobiles manufactured, some say about one-half, come from

the section in and around Detroit, Mich. When meat packing is mentioned, Chicago at once comes to mind. This is by far the largest of a dozen great meat-packing centers of the nation. Much of our steel output comes from Pittsburgh and the region near by in eastern Ohio. New York and New England furnish more than half of our shoes and almost a third of our textiles and clothing. Wisconsin is famous for cheese and dairy products. Examples could be multiplied indefinitely, but these will serve to show you that certain industries tend to locate in certain regions.

Production Is on a Large Scale.—Instead of the small factory owned and operated by an individual or a family, we now have huge plants covering acres of ground and owned by thousands of people scattered all over the country. In these plants are thousands of workers, quantities of the most modern machinery, and a system that turns out products by the thousands each day. This does not mean that there are no longer any small plants employing a relatively few workers, but it does mean that modern production is to a large extent conducted on a vast scale.

Specialization and Division of Labor Prevail.—When large-scale production was introduced, it was no longer practical to have one worker make the entire product. This would have slowed down the process, and the purpose of mass production would have been defeated. In order to turn out thousands of articles in one day, the task was broken up into many small jobs each of which could be performed easily and quickly by workers. This made the worker a specialist to a certain extent. Today in some plants the tasks are so minutely divided that some workers do no more than put on a certain nut or tend one small part of a machine.

Machines Have Taken the Place of Men.—This is a well-known characteristic of modern production and one that has caused much bitterness among workers. But it is considered a necessary change if large-scale production is to continue. With the simplification of tasks and the multiplication of these small tasks has come the discovery that a machine can do many jobs better than the men themselves and at a much lower cost. Competition in industry is keen, and unit cost of production is the factor that determines whether some industries will prosper or fail. If the machine will lower production costs and enable the producer to sell his product at a lower price to consumers and a:

the same time make a good profit, he will introduce the machine. This is what has happened in industry after industry until today the machine is the outstanding characteristic of modern production.

Products Are Standardized.—One very noticeable characteristic of modern production is that so many articles are alike. They have been standardized. A standardized product is one that conforms to some established and generally recognized type. It is essential to large output that the articles manufactured be alike because this will reduce the cost of producing them. It is also very convenient to consumers, for any person driving a standard make of automobile can find parts that will fit exactly in his car if it needs some repair. It does not matter in what part of the country one may be at the time; he can feel sure that he will find just what he wants. Similarly, an electric-light bulb can be bought anywhere with full assurance that it will fit the socket at home. These examples could be multiplied many times without exhausting the illustrations.

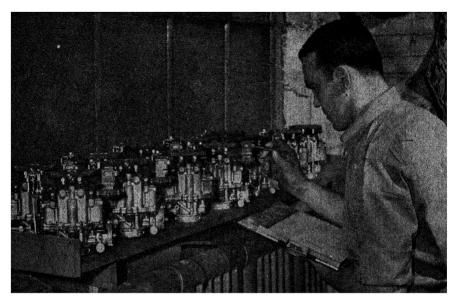
Summary.—The consumer has as much interest in the problem of producing goods as he has in the problem of consuming goods. Production is the process of



Courtesy of Commercial Solvents Corporation, Martin's Photo Shop

SPECIALIZATION OF LABOR—These girls working on a conveyor belt are packaging penicillin, the new wonder drug. This type of labor is highly specialized, and dexterity and speed are soon developed. Only rarely do such workers become acquainted with other aspects of the manufacture of their product.

goods. Production is the process of creating utilities in commodities and services for the satisfaction of human wants. Although man cannot



Lambert from Frederic Lewis

STANDARDIZATION—This man is inspecting carburetors, which are a standardized product. This means that if the carburetor of your family car should prove defective, it could be satisfactorily exchanged for a replacement such as those shown above.

actually create goods, he can take the materials nature furnishes him and change them in many ways so that they will be more useful to him. Production and consumption are opposites, but each is necessary to the other.

In order to have the process of production function efficiently several factors are needed. There must be natural resources and there must be labor to change these resources into useful products. There must be capital if we are to have the tools and machinery necessary to provide for our needs. The process must be coordinated and controlled by management in the interest of efficiency and well-being. Finally, the government must regulate the process and lay down rules for its proper operation.

Modern production is a very complicated process and is distinguished by several outstanding characteristics. Industries are localized to a large extent; goods are produced in large quantities at low cost; labor is divided into small tasks which are easily learned and quickly performed; machines have taken the place of men to a large extent; and the products are standardized.

#### Questions to Test Your Knowledge

- 1. Why is the consumer interested in production?
- 2. Define production.

- 3. What is the relation between consumption and production?
- 4. Name the factors needed to make production function efficiently.
- 5. What is included under the term natural resources?
- 6. What part does labor perform in production?
- 7. Define capital.
- 8. What is understood by the term management?
- 9. Why is government a necessary factor in modern production?
- 10. List the outstanding characteristics of modern production.
- 11. What is meant by the localization of industry?
- 12. What is meant by large-scale production?
- 13. What do you understand by specialization or division of labor?
- 14. What is a standardized product?
- 15. Show that standardized products are helpful to consumers.

### Questions for Discussion and Application

- 1. If man does not actually create anything, what is meant by the expression "made land"?
- 2. Would it be possible to have modern production if any of the five factors were lacking? Discuss.
- 3. How important is management in industry today? Do you think that management of big business is in any way responsible for the high degree of unemployment that has occurred in the recent past? Where else may some or all of the responsibility lie?
- 4. Government has been gradually imposing restrictions on the management of business enterprises during the past few years through the passage of regulatory laws. Do you think production of consumer goods will be increased or improved as a consequence of such laws and such regulations?
- 5. Machines have been condemned because they cause unemployment. Do you think this is wholly true? Has the introduction of machinery to displace labor been of any advantage to workers? to consumers? to producers?
- 6. Discuss the advantages and disadvantages of standardization of products from the point of view of the consumer.

#### Floor Talks and Written Reports

- 1. Interdependence of consumers and producers.
- 2. The national government in production.
- 3. How machines have brought cheaper goods to consumers.

#### Topic for Debate

RESOLVED, That the national government should regulate and control all mass-production industries.

#### For Further Information

Building America, "Men and Machines," Vol. I, No. 3.

Chase, Stuart, "Men and Machines."

Gemmill, P. F., "Fundamentals of Economics," Chaps. IV, V.

Kiekhofer, W. H., "Economic Principles, Problems and Policies," Chaps. III, IV.

Public Affairs Pamphlets, "Machines and Tomorrow's World," No. 25; "America's Factories," No. 55.

#### PROBLEM 6

#### Consumer Benefits from Large-scale Production

Mrs. Brownell has in her home many laborsaving devices that did not exist in her grandmother's day. Then all the housework had to be done by hand. Mrs. Brownell has a vacuum cleaner, an electric refrigerator, a washing machine, an electric range, an automatic toaster, and many smaller gadgets. There is also a nice radio, which all the family enjoys. All these things are possible for the family because they are produced in such large quantities and are so standardized that they can be sold at reasonable cost. Because she has these laborsaving devices, Mr. Brownell has more time to devote to social activities and to the other needs of her family.

- 1. List several other benefits that the Brownells enjoy as a result of these laborsaving devices.
- 2. Do these new gadgets add to the running expenses of the family? How?
- 3. What can Mrs. Brownell do with the time she saves in housework?

# Chapter V

# Nature's Part in Production

#### Aims of This Chapter:

To learn why natural resources are important.

To define the term "land" as used in economics.

To see how the law of diminishing returns operates.

To discover the relation of the Malthusian theory of population to diminishing returns from land.

To learn why natural resources should be conserved.

The previous chapter outlined in a general way the factors of production. We shall now discuss each of these factors in more detail in order that you may see their relative importance and how they perform their part in production. We shall consider natural resources in this chapter.

What Is Meant by Natural Resources?—Nearly everyone knows what is meant when we speak of natural resources, but not everyone is familiar with the meaning the economists give the term. If you examine texts in economics, you will note that the authors use the term "land" rather than natural resources. This has caused some confusion and many pupils are led to believe that only land is important in economics. But natural resources comprise more than land. For our purposes, natural resources will apply to all those gifts of nature which man uses in providing the things that satisfy his wants.

With this explanation of the term "natural resources" and the use by economists of the term "land" to mean the same thing, we shall proceed to a discussion of this factor of production. If we use the term "land," we shall have in mind the physical earth or soil.

Why Are Natural Resources Important?—Without nature there could be no goods and life could not go on as it does. Modern man would find it impossible to maintain his present existence without nature's offerings. Consider for a moment the things nature



Courtesy of Caterpillar Tractor Company

NATURAL RESOURCES—Land is one of the most important of our natural resources. This is a typical farm scene in Michigan, where the soil is especially favorable to the growth of a certain variety of onion.

furnishes us. It supplies us with all kinds of plants, grains, fruits, vegetables, and fish. These make up our sources of food supply. It supplies us with the materials with which we build our homes, furniture, factories, and machines. It supplies us with the water power which operates our factories and mills. It furnishes us with a place upon which to build houses, factories, office buildings, schools, etc. It gives us sunshine and air necessary for life and growth. It provides us with coal, iron, silver, gold, oil, stone, and other minerals which have many uses. This list could be made much longer, but enough has been said to show you how important natural resources are in the modern world.

How Does Land Differ from the Other Factors of Production?— Land, in the sense of earth and soil, differs from the other factors of production in several ways.

Land Cannot Be Increased in Quantity.—The supply of labor can be increased through growth in population or through immigration. Capital can be increased as the need arises. But the supply of land cannot be noticeably increased. It is practically a fixed quantity. We can use scientific methods of cultivation and get land to yield more. We can restore fertility to partly exhausted land. We can clear

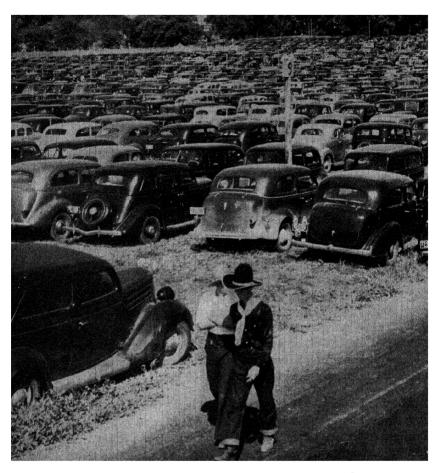
land, drain it, irrigate it, or change its use. But except in rare cases where permanently flooded areas are drained, we can do nothing to increase the quantity of land that is available for our use.

Land Varies in Quality.—Some land is very fertile and produces large crops at little expense; other land lacks fertility and cannot be used for crops at all. It may be suitable for mining, grazing, or building purposes or it may be of no use at all. In the South the soil is well adapted to raising cotton, rice, and tobacco; in the Middle West it is suited to raising grains, such as wheat, corn, and rye. In some parts of the country it is fitted only for mining coal.

Land Differs in Location.—Some pieces of land are more valuable and desirable than others because of their location. Land located in a river valley is likely to be richer and more productive than land located on a mountain slope or far from a river. Land located away from good roads is not so desirable as land located along a paved highway and near a market. Mines are profitable or not according to their location as well as according to their richness or yield. In cities it is a well-known fact that some land brings higher prices because it is so situated that a business can prosper there.

How Is Land Used?—The fact that land differs in quality explains why some farmers cultivate their land in one way and some in another. A farmer in the Middle West who owns many acres of rich land can increase his crops by bringing into use land that has been lying idle. On this land he needs to use only small amounts of labor and tools in order to get a large crop. This is making an extensive use of the land. Land is used extensively when small amounts of labor and capital are used on large acreages of land. We find land used in this manner in those regions where wheat, corn, cotton, and tobacco are raised in large quantities. When a dairy farmer devotes many acres of his land to pasture for his cattle, he is making an extensive use of it.

On the other hand, there are many farmers who do not own much land or much of whose land is not very fertile. They must, however, make a living from the land they own because they have no other they can use. Under these circumstances they try to increase their crops by using more fertilizer and by cultivating it more thoroughly. This is making an intensive use of the land. Land is used intensively when large amounts of labor and capital are used on small acreages or on the same land. This type of cultivation is more often found in European coun-



Courtesy of Farm Security Administration, Photo by Rothstein

EXTENSIVE USE OF LAND—This large parking ground at an Iowa State Fair is being used extensively because only a small amount of capital is involved.

tries than in the United States. However, it is found in certain areas of our own country. Truck gardeners who raise vegetables for a special market cultivate their land intensively. Likewise, those who raise apples, peaches, and citrus fruits use the intensive method to a large extent.

It is not only agricultural land that is used in these different ways. In cities we also find similar variations in the use of land. In a large city like New York or Chicago office buildings, apartment houses, and hotels are built high into the air because of limited space; this is using the land intensively. In a small town the buildings are lower, cheaper, and separated by more open spaces; this is using the land

extensively. When a city sets aside a large tract of land for a park or a municipal golf course, it is using the land extensively. When a building is torn down and the space used for a parking lot, it is possibly a change from an intensive use to an extensive use of the land.

Are Natural Resources Limited in Yield?—The law of diminishing returns affects three of the factors of production: land, labor, and capital. Farmers and those engaged in such industries as mining, fishing, and lumbering have felt its effects. Moreover, those who erect large office buildings, apartment houses, and hotels in cities know that there is a limit to the size of the building that can be erected profitably.

Let us see how the law operates in the case of agricultural land. Suppose that a certain farmer has five acres of land which he wishes to devote to the raising of onions. His experience is shown in the accompanying table.

Acres planted	Investment in labor and capital	Total yield, bushels	Increased yield, bushels	Yield per dollar, bushels	
5	\$20	100			
5	30	180	80	6	
5	40	280	100	7	
5	50	400	120	8	
5	60	450	50	71/2	
5	70	490	40	7	

An examination of the table shows that as the farmer added more capital and labor each year, his total yield increased and the yield for each dollar likewise increased, until a certain point was reached. When the farmer invested \$60 in the cultivation of his five acres, he discovered that, although the total yield increased he did not obtain as many bushels for each dollar as before. The increased yield also showed a decline from 120 bushels to 50 bushels. At this point diminishing returns set in. The law may be stated as follows: When successive equal expenditures of labor and capital are applied to the utilization of a given natural resource, a point is reached after which further expenditures do not produce returns in proportion to the expenditures.

The fact that this particular five acres of land have reached the point of diminishing returns does not necessarily mean that the farmer will cease to raise onions on them. Whether he continues to raise onions on this land will depend upon how much he can get for his



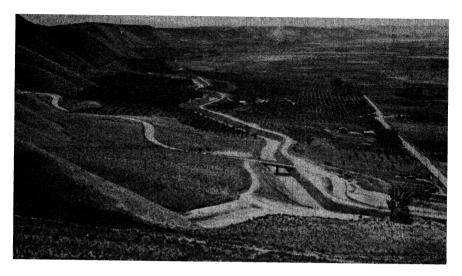
Courtesy of Soil Conservation Service

STRIP CROPPING—Farmers are encouraged to cultivate scientifically. The Texan farmer above is plowing his field in curves following the contour of the land. He has planted different kinds of crops in alternate bands, a method of soil conservation known as strip cropping. The strip of the close-growing crop catches the soil washed from the cultivated strip.

onions in the market. If we assume that at the point of diminishing returns, it cost the farmer 15 cents a bushel to raise the onions and 10 cents more a bushel for transportation and commissions, he can continue to raise onions profitably as long as he gets more than 25 cents a bushel. When it costs him more to raise the onions, get them to market, and pay commissions than he can sell them for, he will stop raising onions on this land. He has passed what is known as the point of most efficient use of the land. Some call it the "margin of intensive cultivation."

Farmers are anxious to counteract the effects of diminishing returns from land because they want to make profits and because they cannot abandon farming. What can be done to ward off the effects of the law? Three suggestions have been made: (1) Farmers can improve their methods of cultivation by rotating crops, using better fertilizers and seeds, and by using more scientific methods and machinery. (2) In some cases they can make use of land not now used for crop raising and develop a system of irrigation on dry land. (3) Transportation facilities can be improved, making it easier and cheaper for farmers to market their crops.

Diminishing Returns in City Land.—In the case of city land, fertility is not so important as location. Because land in cities available for



Courtesy of Farm Security Administration, Photo by Lee

AN IRRIGATION SYSTEM—Much can be done through irrigation to improve the farmer's crop. Above we see wide irrigation ditches in Idaho. The water for the ditches is supplied by the Black Canyon Reservoir.

building purposes is relatively limited, tall buildings will have to be erected if there is to be profitable return on the investment. But the taller the building, the greater the cost of erecting it. It is necessary to have deeper and stronger foundations; space must be set aside for elevators and lobbies; in some cities building laws require upper stories to be set back from the lower stories for air space and light. As the building rises higher and higher, a point will be reached beyond which it will not pay to add any more stories. This has been proved in many office buildings and apartment houses in our large cities.

How Does the Law of Proportionality Operate?—Labor is also affected by the principle of diminishing returns. The owner of a factory who employs a fixed number of workers finds that he cannot go on adding machines and materials indefinitely. He finds that there is a limit to what his fixed number of workers can produce. Men can perform only so much work and, no matter how many machines are used and how much raw material is provided, this output cannot be increased beyond a certain point or in proportion to the increase in capital.

If a certain factory contains twenty stamping machines and no more can be installed, how long can the owner continue to increase the number of workers and the amount of raw materials and still obtain an increase in product? It is not difficult to see that as more

workers are engaged, there may be too many to operate the machines efficiently and they will be in each other's way. Instead of increasing production they will tend to reduce it. Thus there is a limit to what can be done with a fixed number of machines; or a point is reached beyond which the output of workers will not increase in proportion to their increase in numbers.

The law of proportionality may be stated as follows: If one of the three factors, land, labor, and capital, is fixed and the other two are increased, a point will be reached after which any increase in the two variable factors will not produce returns in proportion to the increase.

Is There Danger of a Scarcity of Food?—Closely related to the law of diminishing returns is a theory of population expounded by an English economist named Thomas Malthus. Malthus stated that population tended to increase faster than the food supply to sustain it. Unless there were checks upon the growth of population, a time would come when people would be faced with starvation. Food could not be produced fast enough to supply the people who were being born. Among the checks to population increase Malthus named wars, famines, plagues, and late marriages. Malthus had the law of diminishing returns in mind when he announced his theory, for his theory of population pressure upon food supply rests on the assumptions of fixed supply of land and diminishing returns from land.

Malthus was not able to foresee the great improvements that have been made in agriculture; nor could he foresee the many machines that have made farming easier and increased the production of food, such as tractors, planters, reapers, and others. He could not know that great strides would be made by science in developing new processes of preserving food for future use. In his day emphasis was placed upon the *quantity* of food consumed. Today the emphasis is on the *kind and quality* of food consumed. The predictions of Malthus have not yet been fulfilled and probably never will be. However, Malthus performed a service to the world because his theory caused men to think about the consequences of the law of diminishing returns and centered attention on the conservation of natural resources.

There Is a Need to Conserve Natural Resources.—At this point certain facts about natural resources should be clear. One of these facts is that man cannot continue to use natural resources recklessly without paying a big price. If he does not replace much of what he uses, there will be none left for future generations. Thus it is vitally

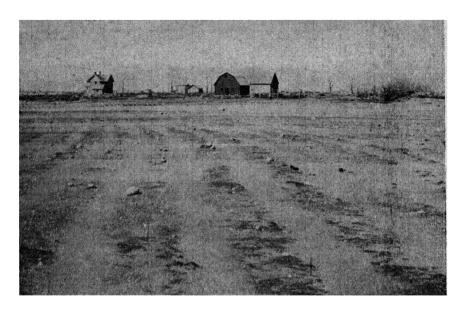
necessary that natural resources be conserved. This sounds like nothing more than common sense, yet in the past man has used natural resources as though they were inexhaustible; only now is he beginning to see his folly and to make efforts toward conserving natural resources.

Some Resources Are Replaceable, Others Are Not.—Natural resources may be divided into two kinds: (1) those which cannot be replaced and (2) those which can be replaced. Among those which cannot be replaced are coal, oil, metals, and several minerals. We have been extracting oil, coal, and other minerals in huge quantities for many years with the idea of making use of them while we can. Today we use oil for fuel and for power to drive our battleships and to operate our mills. The world is almost completely dependent upon oil both in time of peace and of war. In some regions we have almost exhausted our coal deposits. But in spite of the scale upon which we have used our resources of coal and oil, we are told that they will last for many years to come.

Fortunately, there are some who foresee the time when we shall be without the much-needed supplies from nature and who, therefore, are engaged in providing substitutes. We are already familiar with some of them, such as synthetic rubber, rayon, nylon, and many plastics. Experiments are being carried on to develop useful products from soybeans to take the place of steel and wood. But even though substitutes are being found, we should not continue the reckless use of irreplaceable resources.

Among the resources that can be replaced are forests, soil, and animal products. Although these are capable of being replaced, it must not be forgotten that it takes years to do so. A tree can be cut down in a few minutes, but it will take many years before another of equal size has taken its place. Soil is wasted in many ways and in a short time; it is most difficult to replace it. At the present time we are greatly disturbed about the waste of good soil and forests.

Much soil has been washed away by floods or blown away by winds. It is estimated that millions of tons of good topsoil are carried off to sea each year. You have heard of the dust storms that carried away many tons of rich soil from farms in the West. You also know what happened in the West when many acres of good land became useless because of droughts. The fact is that we are using up our soil faster than it is being made. Much of this waste could have been pre-



Courtesy of Soil Conservation Service

BEFORE—This is a scene in South Dakota, showing the results of erosion by the wind. The subsoil is exposed, with rocks scattered on the surface. Such soil is not suitable for growing useful crops.



Courtesy of Soil Conservation Service

AFTER—This is the same farm as shown in the picture above after cover crops of grass had been planted. Soon this land will be ready for growing good crops again, and the owner will receive income from it. This is an example of what is being done to restore land that has been allowed to become useless.

vente'l if more thought had been given to preserving it. Those who claim to know something about the matter say that if farmers had left more of their soil in grass instead of plowing it up to raise crops, the drought would not have done so much damage. Grass holds moisture. When there is no moisture in the ground, there is nothing to hold the soil. It then crumbles to dust and is easily blown away.

Our desire to cut the forests so rapidly and so closely has resulted in exposing the soil to floods and erosion. Trees are needed to help hold the rains so that water may soak into the ground instead of running off, taking the soil with it. This is especially true of forests that are situated on hillsides.

What Can Be Done to Conserve Our Resources?—It is easy to criticize what we have done in the past and to see where mistakes have been made. But it is more difficult to correct those mistakes. However, scientists and the government have made several suggestions. They urge farmers to use more scientific methods of cultivation, to plow deeper furrows to catch and hold water. They also urge that, instead of plowing ground in straight furrows as is the usual custom, farmers plow furrows in curves around slopes. These will hold the water from running downhill quickly and wastefully. The government has undertaken many projects for flood control by building dams across streams to hold back water, allowing it to soak into the soil instead of rushing downstream to cause floods and damage. The government has also undertaken reforestation projects and is cutting only trees that are mature, leaving the others to grow into larger trees.

Summary.—Natural resources are the gifts of nature which man uses in providing the things that satisfy his wants. Nature is the source of all material goods. It furnishes us a place upon which to build our houses and factories and a source of supply of foods and minerals. Of all natural resources land is perhaps the one that interests us most. Land differs from the other factors of production in that it is limited in quantity and varies in quality and location.

Because land varies in quality, some of it is cultivated in an extensive manner while other land is cultivated in an intensive manner. Land is also subject to the law of diminishing returns. This law applies not only to agricultural land and to city land but also to labor and to capital.

Closely related to the law of diminishing returns from land is the

Malthusian theory of population. This theory states that population, if unchecked, tends to grow faster than the food supply to take care of it. If no efforts had been made to overcome the effects of the law of diminishing returns, the conclusions of Malthus might have proved correct. But new inventions, new processes of manufacture, new foods, new methods of preserving food, and more attention to the kind and quality of food eaten rather than the quantity have postponed indefinitely the serious consequences predicted by Malthus.

The wasteful manner in which we have been using up our natural resources, taken in connection with the law of diminishing returns and the warnings of Malthus, has caused us to think more seriously about the future of our resources. These resources which cannot be replaced will have to be used more wisely unless we are content to exhaust them in a generation or two. Farmers will have to adopt more scientific methods of cultivation, and the government will have to help in flood control and reforestation. Fortunately, we are waking up and serious efforts are being made to conserve what is left of irreplaceable resources by using substitute products to a large extent.

#### Questions to Test Your Knowledge

- 1. What is included under the term natural resources?
- 2. Explain the differences in land.
- 3. How does the extensive use of land differ from intensive use?
- 4. State the law of diminishing returns as applied to agricultural land.
- 5. Explain how this law applies to labor; to capital.
- 6. State the Malthusian theory.
- 7. Why have the predictions of Malthus failed to come true?
- 8. What are the two general classes of natural resources?
- 9. Name some resources that come under each classification.
- 10. What mistakes have been made in using natural resources?
- 11. What may farmers do to conserve the soil?
- 12. What can the government do to help conserve resources?

### Questions for Discussion and Application

1. How does the supply of land differ from the supply of other kinds of wealth? from the supply of labor?

- 2. Find examples in your own community of the extensive use of land; of the intensive use of land. Why are these particular pieces of land used in these ways?
- 3. Discuss the services the Malthusian theory has performed.
- 4. Why would it be unwise to erect a fifty-story office building in a city of 40,000 people? Does the law of diminishing returns apply to the erection of such buildings? Discuss.
- 5. Explain why businessmen are interested in the operation of the law of diminishing returns.
- 6. Show that there is a close relationship between the building of good roads in rural sections and the operation of the law of diminishing returns.
- Discuss the social and economic effects of wasteful uses of our natural resources.

#### Floor Talks and Written Reports

- 1. Diminishing returns and conservation.
- 2. Implications of the Malthusian theory.
- 3. Government responsibility in conservation.

#### Topic for Debate

RESOLVED, That all natural resources should be owned and controlled by the Federal government.

#### For Further Information

Bennett, H. H., "Soil Conservation and Flood Control." Building America, "Conservation," Vol. II. No. 7.

Chase, Stuart, "Rich Land, Poor Land."

Glover, Katherine, "America Begins Again."

Public Affairs Pamphlets, "Farmers without Land," No. 12; "Saving Our Soil," No. 14; "Adrift on the Land," No. 42.

#### PROBLEM 7

#### Diminishing Returns

Using the figures given on the following page, find the point of diminishing returns in erecting this office building.

	Amount invested	Total rent	Rate of return
Building lot	\$10,000		
Foundation and roof	 13,000		1
First floor.	15,000	\$ 3,800	1
Second floor	10,000	5,280	l
Third floor.	8,000	6,720	1
Fourth floor .	 8,000	8,000	l
Fifth floor	 8,000	9,216	1
Sixth floor.	8,000	10,400	
Seventh floor	 8,000	11,000	1
Eighth floor	8,000	11,520	

# Chapter VI

# How Man Contributes to Production

#### Aims of This Chapter:

To learn what labor is and what forms it takes.

To examine the characteristics of labor.

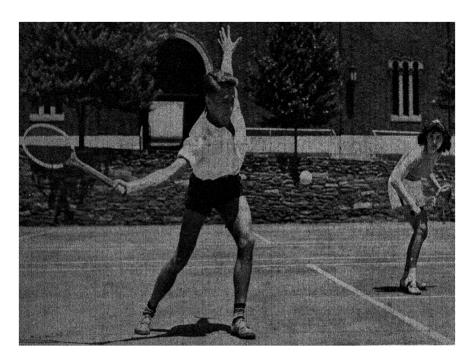
To find out how labor can become more efficient.

To learn the advantages and disadvantages of specialization.

Nature's part in the process of production is very important, but it would be only a small part if it were not for the fact that man uses the materials of nature and fashions them to his uses. Our modern process of production would not function efficiently nor would we be able to enjoy many necessities and comforts if we depended wholly upon nature. Another factor must make its contribution and this factor is man. Man contributes labor, which is the subject of this chapter.

What Is Labor?—The term "labor" has been used in several senses. Some think of labor as only the hard work done by manual workers. Others think it includes the tasks performed by those employed in factories excluding the work of executives and clerks. When used by economists, the term has a wider meaning: it includes all the efforts made by man to earn a living.

When you play a vigorous game of tennis, cultivate a home garden, or work at some hobby, you are using energy; yet this is not labor in the sense that economists use the term. It all seems to lie in the purpose for which the exertion is made. When a man uses his energy and time to earn money in order to obtain goods to satisfy his wants or to support himself and his dependents, he is engaged in labor. On the other hand, when he uses his energy and time doing things for amusement or relaxation, it is called "play." In each case the amount



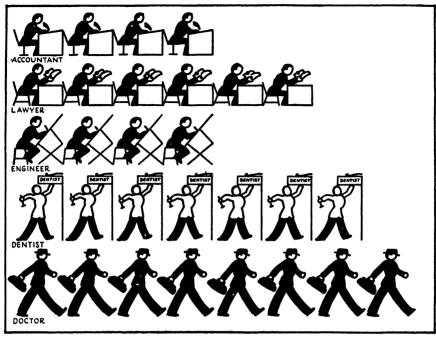
Lambert from Frederic Lewis

WHAT IS LABOR?—This boy is using a good deal of energy in the tennis game, yet, since his purpose is play and not earning money, he is not working. Professional tennis, on the other hand, is considered labor.

of physical energy used may be the same, but the purpose is different. Moreover, all labor is not performed by the hands or the muscles. Many use mental energy in making a living, and this is labor in the economic sense. Labor is any effort exerted by man, whether physical or mental, in the process of earning a living.

All Kinds of Labor Are Not Alike.—All men do not earn their living in the same way. There are different kinds of labor.

Skilled, Semiskilled, and Unskilled Labor.—All labor belongs to one of these three classes. There are varying degrees of skill. Skilled labor includes all those who have had extensive training and have gained experience on the job. In many cases these workers have served a period of apprenticeship before they were permitted to undertake a major task. Skilled workers can usually command a higher wage than other workers. Semiskilled workers are those who have gained some skill in their work but have not yet advanced sufficiently to be classified as skilled. Unskilled workers are those who have had no training for a job and who are usually engaged in tasks that require no skill at all. This class outnumbers all others and receives the lowest wage.



Frank Gawel

YEARS OF TRAINING—In a large Eastern university, the following are the general requirements for the professions in the above chart:

Accountant—two years in college and two years in a school of business. An additional year is required to pass the CPA examination.

Lawyer-a minimum of three years in college and three years in law school.

Engineer—two years of general college work and two years in engineering school.

Dentist—three-year college course and four years in dental school.

Doctor—three or four years of college work and four years in medical school. One year of internship is usually taken, although in this case it is not a state requirement. In all cases, "years" refers to academic years.

Physical and Mental Labor.—The definition suggests another classification of labor: physical and mental. Physical labor is the kind that is performed by muscular effort while mental labor is the kind in which the mind is used chiefly. However, this distinction is not to be interpreted too strictly. It would be almost impossible to name any kind of labor in which both muscle and brain are not used to some extent. Many unskilled workers and some skilled workers depend to a large extent upon their strength, but they depend also upon skill and training which involves nerves, brain, and thought. Bookkeepers and accountants engage chiefly in mental exercises and skill; yet they use

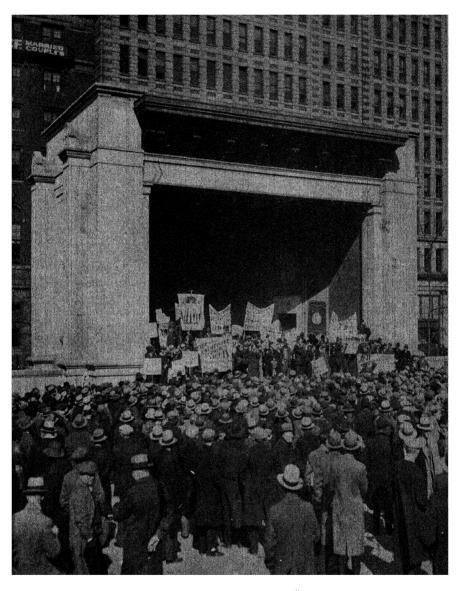
their hands to a large extent. Physical labor includes those engaged in manual work of the lowest class as well as those engaged in the highly skilled activities. Mental labor includes those engaged in intellectual tasks as well as those engaged in clerical tasks which require little or no education and training.

Professional Labor.—This is one form of mental labor but it includes such a large and distinctive group that it is placed in a class by itself. Professional workers usually have had long years of training and must often prove their fitness by a severe test. A high degree of intelligence is also required. In this class, to name a few examples, we find doctors, lawyers, teachers, priests, ministers, dentists, and architects.

Labor of Administration.—This is another type of mental labor which has increased in importance with the development of huge business organizations. In this group we find the managers of large corporations and railroads, college presidents, heads of foundations and research organizations, government officials, and the superintendents of school systems. A high type of education, a knowledge of finance, and much training are required for administrative success. Salaries are high because this type of labor is relatively scarce.

What Are the Characteristics of Labor?—The Clayton Antitrust Act of 1914 stated that labor should not be considered a commodity and excluded it from the provisions of the antitrust laws. Others, however, look upon labor as a commodity because it is bought and sold like other commodities and is similarly subject to economic laws. Laborers are paid wages which are determined to a large extent by the factors of supply and demand. Legally, then, labor is not a commodity but in an economic sense it is. But labor has certain characteristics that distinguish it from other commodities.

The Laborer Cannot Separate Himself from His Product.—A manufacturer of washing machines does not have to go along with his machines when they are sold, but the laborer must be present when his product, labor, is sold. The manufacturer can remain in his office and send his machines all over the world without moving from his desk. He can take orders and fill them at will. But the laborer cannot accept an order for work to be done by him and send the completed work to someone else while he himself remains at home. Labor cannot be crated or wrapped in packages and shipped anywhere it is wanted. The worker must accompany his work for he and it are one and indivisible. This means much to the worker because when working



Wide World Photo

UNEMPLOYMENT PROTEST—In 1933 unemployed workers held a mass meeting at City Hall Plaza in Philadelphia. In that year the unemployed population was at its peak and numbered more than 14,000,000, or nearly one-third of the entire working population of the United States.



Press Association, Inc.

SKILLED LABOR REQUIRES LONG TRAINING—Here a flight engineer presides over a large panel on the flight deck of the Mars. This panel controls and indicates every phase of activity of the mammoth plane. The engineer underwent a long period of training in order to master its intricacies.

conditions are not favorable he nay become ill or be injured. He thus loses valuable time and earns ess money. Moreover, because the working days of a man are limited, working conditions which tend to shorten this time are serious matters for him. In recognition of this fact laws have been passed to protect the worker and to improve the conditions under which he must work.

Labor Is Perishable.—If the manufacturer of washing machines is not able to sell his machines at once, he can store them until a better opportunity comes. He can withhold his product from the market at any time and for almost any reason. But the worker cannot do this with his product. If he is unable to work

for a day, he loses the income from his labor for that day and cannot make it up later. This is the reason why workers fear unemployment and often accept lower wages rather than not work at all.

Supply of Labor Changes Slowly.—Here again the manufacturer of washing machines has an advantage over the worker. It there should be a sudden increase in the demand for his machines, the manufacturer can speed up production and supply the demand. Likewise, if the demand declines, he can operate his plant part time or close it entirely. In other words, the manufacturer can adjust his product to meet the changes in demand for it. The laborer, however, cannot do this with his product. The number of available workers for a certain type of work does not change much from day to day. If the demand for sanitary engineers should suddenly increase, it would not be possible to supply them at once. It would take some time to produce and train the workers for this task. This was illustrated in the Second World War by the shortage of skilled mechanics needed for the various defense projects and for the manufacture of machine tools, airplanes,

motors, and other war materials. It became necessary to train many thousands of men and women to meet the demand and even then it took two years to do it. It takes many years of preparation and practice to become a skilled surgeon or a capable lawyer. Moreover, when the demand for a certain type of worker falls off, the old supply still remains and these laborers lose time and money while waiting to be absorbed into other occupations. Thus it takes a long time for the supply of almost any type of skilled labor to adjust itself to the changing demands of industry.

Labor Does Not Move Readily from Place to Place.—If washing machines cannot be sold readily and profitably in one place, they can be shipped to some other locality where they will sell. All economic goods can be moved about wherever they can be sold and used best. Here again labor differs from other commodities. This does not mean that labor never moves about in search of work and wages. But workers do not move readily from place to place even though work and wages may be had by doing so. There are several reasons for this.

Workers frequently own their homes and dislike to give them up to go elsewhere. It may mean a financial loss which they cannot afford to take. Workers are reluctant to break social ties and disturb the education of their children. Again it costs money for a worker to move his family and his furniture from place to place, and he does not always have the money with which to do this. Finally, workers hesitate to move to a new place where they will be unknown. They feel that they stand a better chance of finding work, if they become unemployed, in a place where they are known than in a strange locality where no one knows anything about them.

These reasons may seem foolish, but to the workers they are real. They account for the fact that there may be much employment and high wages in one locality because of a shortage of labor, while in another locality many of the same type of workers are earning low wages or are only partly employed because there is an oversupply of this type of worker.

What Are the Sources of Labor Supply?—It is not difficult to understand how the *demand* for labor arises. Workers are wanted because they are needed in production of goods, and profits can be made by employing them. Employers are always looking for workers of one type or another. But what determines the *supply* of labor? There



Ewing Galloway

IMMIGRATION SWELLED OUR LABOR SUPPLY—Potential American laborers are shown grouped in a waiting room at Ellis Island, tagged for their destinations. At the close of the First World War scenes such as this were common.

are two factors that enter into the supply of labor: increase in population and immigration.

Population Growth.—The most important factor affecting the supply of labor is the growth of population. As the population of a country increases, the labor supply increases and vice versa. When the rate of population growth declines, it means a dwindling labor supply. For many decades the census reports showed a healthy rate of increase in population growth. The 1940 census also showed an increase in total population but a decline in the rate of this growth. This is of much significance to the labor supply of the future.

Immigration.—Another source of labor supply is immigration. For many years the United States permitted almost unrestricted immigration. Our labor supply was increased each year by millions of workers from other countries. This gave us an abundance of workers at low wages; it enabled us to build our railroads, canals, and highways, to establish large industries, and to operate our mines.

The greater number of these immigrants, however, were unskilled workers with low standards of living and were willing to work for lower wages than American workers. They did not join unions, and this made it difficult for the unions to bargain effectively with the employers. For these reasons organized labor opposed unrestricted immigration and finally succeeded in having laws passed which practically put an end to immigration. This means that our future supply of labor will depend mainly upon population increase.

How Can Labor Be Made More Efficient?—Because of the decline in the rate of population growth and the severe restrictions upon immigration, workers will have to become more efficient if we are to continue to produce all the commodities and services required by society. An increase in the efficiency of the workers will increase the output and thus tend to raise the standard of living. This is what everyone desires. But the problem of increasing the efficiency of our present labor force is not easy to solve because it involves complex human reactions and behavior. However, many ways of increasing labor efficiency have been suggested; some of them have been tried with more or less success.

Most workers are honest and intend to earn their wages. But they cannot always do their best in the most efficient manner because of certain factors that they cannot control. Working conditions may not be satisfactory and the attitude of the employer may not be very cooperative or appreciative.

The worker can do something to increase his efficiency through his own efforts. He can keep himself physically fit, increase his education and training, and be mentally alert. But these things alone will not solve the problem. Employers have a great responsibility to do something to make workers more satisfied and loyal and to encourage them to do their best. Let us examine briefly some of the things employers can do to help their workers become more efficient.

Paying Adequate Wages.—By adequate wages is meant the payment of wages sufficiently high to enable workers to maintain a good standard of living. Every worker should be able to enjoy many comforts and some luxuries; and it should be possible for his family to enjoy more social opportunities than in the past. From the point of view of the employer it is said to be good business to have employees interested in their work and loyal to their company. Every worker is in a position to affect the profits of a business. The best way to arouse the

worker's interest is to make it worth his while financially through the payment of an adequate wage.

Permitting Workers to Share in Profits.—In addition to paying an adequate wage some employers have attempted to interest their employees still further and to make them even more loyal by permitting them to share in the profits of the business. Profit sharing means the payment to employees of a part of the profits at stated intervals. The usual procedure is for the employer to announce at the beginning of a period the conditions under which the workers will share and the ratio of the division.

Even though this plan gives employees extra sums of money, objections to it have been raised. Workers say that they often receive such small sums that there is little incentive to work harder and to produce more. Another objection is that when payments cease after a period of years, the workers feel that they have been deprived of something that is rightfully theirs.

Payment of Retirement Pensions.—Workers are not able to save enough to provide for a comfortable old age. Some enlightened employers realize this and provide plans for paying pensions to retired workers. They feel that if their employees can be assured of being taken care of after retirement, they will be better and more loyal workers. Although some of these company plans have worked successfully, there are serious objections to them.

Older workers who are near the retirement age like the plan but the younger workers are not so enthusiastic because of the long time they will have to wait for a pension. Organized labor has been opposed to such plans because they make it more difficult to bargain collectively and to get men to join unions. Whereas the passage of the Social Security Act put an end to some of these plans, many large corporations have continued their own private plans in addition to the governmental program.

Provisions for Unembloyment.—Another great hindrance to efficiency is the fear of losing a job or of being unemployed for a period of time. Corporations have not found it easy to solve this problem although they realize that it is to their advantage to remove the fear if possible. Some employers have introduced plans to do away with seasonal unemployment. They spread out production over the year whenever possible instead of concentrating it in the busy season. Other com-

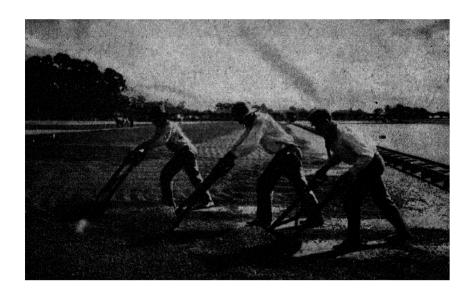
panies have a plan by which they guarantee the worker a stated number of weeks of work during the year. If employment falls below this level, the worker receives a certain percentage of his wages for the difference between the time actually worked and the time guaranteed. Other employers have provided for a dismissal wage. That is, when a man is laid off because work is slack, he is paid a sum of money depending upon his average wages and length of service. Many corporations have dropped these plans since the Social Security Act now makes other provision for unemployment insurance.

The plans outlined above are by no means all that have been tried to make workers more efficient and loyal. Space does not permit us to describe other plans for improving working conditions, for social-welfare work among workers and their families, and for employee representation plans to discuss grievances with employers. However, enough has been said to illustrate what enlightened employers are doing.

Division of Labor Is Important in Modern Production.—There remains one other important characteristic of modern production which has assumed great prominence. This is division of labor which is defined as the system whereby the operations necessary to make a finished product are so minutely divided that each worker performs only one or at most only a few simple operations.

Simble Division of Labor or Division by Occupations.—Primitive man was obliged to provide for his wants all by himself. If he wanted a shelter, he had to build it himself; if he wished to live, he had to provide his own food and clothing. As communities developed, this method was unsatisfactory. Man soon discovered that more could be accomplished in a better way and in a shorter time if each individual devoted himself to some one occupation and permitted other individuals to supply his other wants. This was the beginning of what we now call "trades." Thus one man became a carpenter, one a tailor, one a baker, and so on. Each man did all the work of his trade. This is called the simple "division of labor" or division by occupations.

Complex Division of Labor.—Under simple division of labor it took time to produce certain goods, and the amount produced was somewhat limited. When factories were built, it was found desirable to split up the occupations. Labor was further divided so that within the trades and occupations each man performed only a small part of



Brazilian Government Trade Bureau

COFFEE IN BRAZIL—No other large country is so dependent upon a single product as Brazil is upon coffee. Here coffee growing has been more successful than in any other region, as Brazil has an unusual number of natural advantages for the cultivation of this particular crop.

The picture shows coffee seeds, still enclosed in a thin husk, being spread over an extensive brick-floored area to dry in the sun for twelve to twenty-five days. If wet by rain, the coffee is injured.

the trade. Under this arrangement no one worker produced a complete product. Thus, in building a house, one group erected the frame and did the rough work; another group put on the siding and the roof; still another group attended to the interior work.

Complex division of labor is seen best in large industries. It has been carried to such extremes today that there are said to be over 150 distinct operations in the making of a pair of shoes. The automobile plant with its assembly line requires thousands of workers, each of whom performs one small task, such as putting on a certain nut.

Territorial Division of Labor.—Division of labor has been extended from the factory and the shop to sections of the country and even to entire nations. This is called "territorial division" of labor. It can be illustrated by a few examples. In the United States, the South devotes itself to growing cotton, rice, and tobacco; the Middle West specializes in cereal grains; Pennsylvania produces our anthracite coal; Florida,

California, and Texas produce quantities of citrus fruits; the region around Detroit supplies most of our automobiles; and textile manufacturing is carried on largely in the Eastern states. Thus each section devotes its energies to producing that for which it is best fitted.

In the case of nations we find Brazil specializing in coffee production; China in tea; and the South Sea Islands in rubber and tin. This territorial division of labor has developed because of certain advantages, such as nearness to raw materials, water power, good soil, climate, markets, and cheap labor.

Are There Any Advantages in Specialization?—There must be many advantages in the division of labor or it would not have become so prevalent. What are these advantages?

Workers Become More Skillful.—When a worker has only a small task to perform, he can soon become expert in doing it. Since he does the same thing over and over again day after day, his skill increases.

Much Time Is Saved.—The worker in a large plant uses only one or two tools or operates one certain machine. He does not have to pick up and lay down several tools but uses the same tool all the time. What is more he does not have to move far from his machine or bench or take many steps in performing his task. This saves much time. Time is also saved in training the worker. Only a few days are required to teach a man all he needs to know about his job.

All Kinds of Workers Can Be Employed.—Where the work is divided into small tasks, these tasks vary, some requiring much skill while others require little or no skill at all. Thus workers of all degrees of skill can find work at tasks which they are able to perform. Older workers as well as young can be used. Women too can find work. This is true not only of factories but of many other kinds of business. In large department stores, in banks, and in many offices, there are tasks that call for varying abilities and these give employment to all types of workers.

It Develops Cooperation among Workers.—When men work side by side, each performing a task that must be completed before the next worker can do his part, they soon learn that cooperation is important. Likewise these men learn that they have many common interests. All are affected by the same working conditions. It is not strange, then, that workers in a large factory form associations aimed to aid them to better their conditions and wages.

It Is Easier to Supervise and Inspect the Work.—In large plants the products are standardized and the processes of manufacture are carried on in departments or by stages. This makes it easier to supervise the workers and to inspect the product to detect imperfections.

It Reduces the Cost of Goods.— Under complex division of labor, each worker cooperates with others in the same plant and thus turns out more products in a given time. Since most of the articles are made according to a definite standard and are all alike, it becomes possible to produce them in large quantities, thus lowering the cost. Furthermore, under this system machines can be operated practically all the time, further reducing the cost of operation.

What Are the Disadvantages in Specialization?—Division of labor has its disadvantages as well as its advantages.

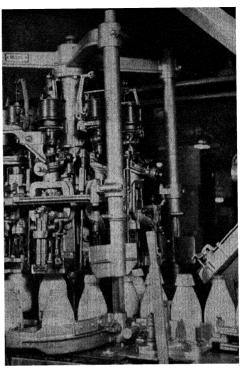
Repetition Has a Deadening Effect upon Workers.—Those who have to perform the same minor task day after day soon become tired of it. What must be the effect upon a worker of inserting bolt No. 13 in a certain place every two minutes of the working day? Is it any wonder he becomes so weary and sometimes so carcless that accidents frequently happen?

Workers Have Little Pride in Workmanship.—Men who have spent many years becoming expert in a particular craft take great pride in the work they do and in the quality of the product they turn out. When a worker makes a beautiful hand-carved table all by himself, he takes great pride in showing it. But when he is limited to doing one particular task in the making of the table, his feeling of pride tends to grow less. Imagine a worker feeling a thrill at seeing an automobile in which he merely installed the battery!

Workers Become Dependent upon One Another.—Although the recognition of dependence upon one another may be the cause of more unity and cooperation among them, workers find that it also has its disadvantages. This was well illustrated in the automobile industry at the time of the sit-down strikes. When the workers on one part of the assembly line chose to sit down at their places and not work, other workers could not go on with their tasks no matter how much they may have wished to do so. Worker No. 450 cannot perform his task until worker No. 449 has completed his part. This becomes a more serious disadvantage when the workers in one plant make it impossi-

ble for workers in an entirely different plant to carry on. The closing down of a steel mill by a strike throws out of work men in other plants that use the steel strips and plates from the first plant.

Specialists Find It Difficult to Adjust Themselves to Other Work.— With the increase in the division of tasks craftsmanship has become less important. Only a short time is now required to learn a single, simple operation. The worker skilled in this small operation knows only one part of the complete routine and has no chance to learn the entire process. If he loses his job, where will he find another? What else is he fitted to do? He may be able to learn quickly to operate a similar machine or to do some other minor job but, unless such jobs are available, he is unfortunate. This



Courtesy of Borden's Farm Products

MACHINES DISPLACE MEN—Speed, efficiency, low cost, and sanitation mark the performance of these machines, which fill, cap, and seal bottles at the rate of 120 per minute.

is especially serious if the worker happens to lose his job when he is over forty-five, after which age he is less adaptable to changes and employers are more reluctant to hire him.

Machines Displace Men.—Large-scale industries make use of machines whenever a machine will perform the operations more cheaply or more accurately than can be done by hand. Then, too, many of the operations can be performed better by machines than by men. Machines are more accurate, last longer, and can be used more continuously. Thus complex division of labor has made it possible and desirable to mechanize industry sometimes at the expense of workers.

**Summary.**—Before natural resources can be made suitable for our use, man must add his labor in making them into goods. Labor

may be skilled, semiskilled, or unskilled. Labor is also physical or mental. Mental labor is classified as professional or administrative.

In many respects labor is similar to a commodity. But it is different from commodities in that the laborer cannot separate himself from his product; labor is perishable; the supply cannot be changed rapidly; and laborers do not move readily from place to place. The supply of labor is dependent upon population increase and immigration.

In order to increase output, raise the standard of living, and cut the costs of goods to consumers, various efforts have been made to make workers more efficient. The most important incentive is to pay adequate wages. Other incentives are profit sharing, paying old-age pensions, providing for periods of unemployment, improving working conditions, and treating workers as human beings. Although some of these plans have brought much good to workers, the danger is that they will be considered paternalistic and as an effort to prevent workers from forming unions for their own protection.

Many workers today are engaged in factories operating under a system of division of labor which divides a large process into many minor tasks that can be performed easily and quickly by all workers. There is division of labor by occupations, complex division of labor, and territorial division of labor. Each of these types has its advantages and disadvantages.

#### Questions to Test Your Knowledge

- 1. Define labor.
- 2. Distinguish between labor and play.
- 3. What are the chief classifications of labor?
- 4. In what sense may labor be called a commodity?
- 5. List the characteristics of labor.
- 6. Show that labor is perishable.
- 7. What are the sources of labor supply?
- 8. What is the chief incentive to make workers more efficient?
- 9. Why is organized labor opposed to unrestricted immigration?
- 10. Explain profit sharing.
- 11. What can a worker do to make himself more efficient?
- 12. Explain what is meant by division of labor.

- 13. Describe the different kinds of specialization.
- 14. State the advantages and disadvantages of specialization.

#### Questions for Discussion and Application

- 1. Show that practically all kinds of labor are both physical and mental.
- 2. Why do economists look upon labor as a commodity? Is it true that labor is subject to many economic laws that affect other economic goods? Explain.
- 3. Labor is not easily moved about. Is this the fault of the workers themselves? Or is it due to conditions and circumstances beyond the control of the workers? Discuss.
- 4. List the reasons for opposition to unrestricted immigration. If our rate of population growth is declining, would it be wise to repeal our restrictive immigration laws? Give your reasons.
- 5. What are incentive wages? What are the motives that impel employers to develop incentive wage plans?
- 6. Why do workers feel skeptical about the various plans formed to interest them in their work and get them to produce more? Why have these plans been called paternalistic?
- 7. Discuss the advantages and disadvantages of territorial division of labor-
- 8. Has division of labor proved beneficial to workers? Discuss.
- 9. Is division of labor possible or practicable in all industries? Why, or why not?

#### Floor Talks and Written Reports

- 1. Declining population and declining labor supply.
- 2. Incentive wages.
- 3. Company-sponsored activities for workers.
- 4. Division of labor and the craftsman.

#### Topic for Debate

RESOLVED, That immigration restrictions should be removed in order to provide a supply of cheap labor.

#### For Further Information

Building America, "Labor," Vol. 3. No. 3. Gemmill, P. F., "Fundamentals of Economics," Chap. VIII.

Public Affairs Pamphlet, "Machines and Tomorrow's World," No. 25.

McGrane, R. C., "Economic Development of the American Nation," Chap. 24.

Taylor, H. H., and Others, "Main Currents in Modern Economic Life," Chap. 33.

#### PROBLEM 8

#### The Craftsman Encounters Division of Labor

John Betterman was born and educated in a small industrial city. After graduation from high school at the age of sixteen, he was apprenticed to a local manufacturer of small motors. After five years of hard work and study he became a full-fledged motormaker and was given a permanent job in the plant. The plant was a small one and John made the entire motor. The motors were recognized as the best of their kind and brought good prices. In a few years John was earning high wages. He was married and had two children whom he sent to the local schools. He owned a comfortable home and an automobile. Both John and his wife were interested in church, civic, and social affairs in their community.

When John was forty years old, his employer sold the plant to a manufacturer of refrigerators in the same city. John was retained by the new owner but his work was changed. Instead of being allowed to make the entire motor, he now made only one part of it. Although this type of work required skill, there was not so much interest in it for John. He did not feel so well satisfied with his work and his pride in what he did declined. He was offered two opportunities to move to another city where he could again become a craftsman as he understood the term. But he did not go. When he was fifty, the corporation for which he worked decided to have the motors made in another city. The workers were told that if they moved to this city their jobs would be good; otherwise they were out of work. John could find no work along his line and finally was obliged to accept a job operating a machine in a tool-grinding shop at a much reduced wage.

- 1. What is an apprentice?
- 2. How did Betterman become a skilled craftsman?
- 3. What does it mean to be a craftsman?
- 4. What might have been the reasons why Betterman did not accept work at his trade in another city?
- 5. List the characteristics of labor illustrated in this problem.
- 6. What conclusions about the effects of specialization upon skilled craftsmen can you draw from this problem?

# Chapter VII

# Capital and How It Functions

#### Aims of This Chapter:

To define capital.

To learn the source of capital.

To classify capital goods.

To learn what capitalistic production is.

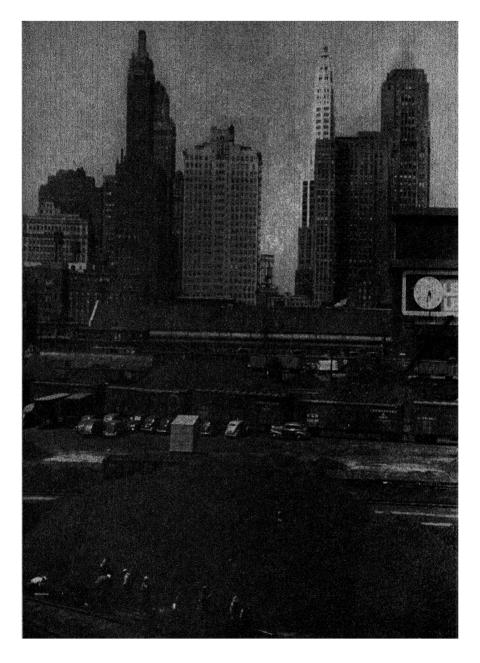
To examine the advantages and disadvantages of big business.

The two primary factors of production, natural resources and labor, have been discussed and their importance has been indicated. But modern production could not function efficiently unless there were tools and machines with which to carry on the process. These tools and machines are capital. In this chapter we shall discuss capital and learn how it functions in production.

What Is Capital?—The term "capital" has been used in so many ways that there is some confusion as to its real meaning. Most people think of capital as money. In their financial statements, banks and corporations list their capital in dollars and cents and this is one reason why capital is confused with money. Capital has a wider meaning than this. To the economist money is only one form of capital. It is a necessary form but nevertheless it is not the only form. Capital is any product of past industry used for further production.

Perhaps it may be well to make a distinction between money as capital and goods as capital. The money invested by individuals in a corporation and used to purchase raw materials, build factories, and operate the business is called *capital funds*. Other forms of capital, such as tools and machines, are called *capital goods*. It is with the latter that we are chiefly concerned. Capital funds often express in monetary terms the dollar and cents value of capital goods.

According to the definition, capital consists of products of labor, and these products are used to make other things. If a product is not



Courtesy of Farm Security Administration

CAPITAL—How many kinds of capital can you find illustrated in this picture of a Chicago railroad yard?

used for further production it is not capital. Thus an old hammer placed as a curio in a museum is no longer capital although it may once have been. Capital includes such things as industrial plants, machinery of all kinds, tools, railways, trucks, busses, commercial planes, warehouses, greenhouses, hotels, office buildings, apartment houses, raw materials to be turned into finished products, etc. Many others could be named and you should try to add some.

What Is the Source of Capital?—How did capital come into existence and how is it replenished? According to the definition, it is a product of past industry used for further production. This means that it is not something that nature itself provided without assistance from man. It does not come into existence until nature and man have cooperated. Again, the product must be put to use in making other things.

In order to have capital there must be a surplus of goods. In other words, people must not consume all that is produced. If we use up everything as fast as it is produced, there will soon be a lack of material from which to make things. But it is not enough just to have a surplus. This surplus must be set aside or saved. If there were no savings, there could be no capital. This applies to goods as well as to money.

Finally, what has been saved must be put to some use; it must be made to work to produce other goods and not be hoarded. People save money and deposit it in banks or buy insurance or invest in bonds and stocks. This money is lent to corporations which use the funds to purchase raw materials, pay labor, and carry on business. If these three steps are followed, capital is not only brought into existence but is kept in use by being worked year after year.

How Is Capital Classified?—Not all capital is alike, nor does it all serve the same purpose in the same way. Capital is classified according to (1) the number of times it can be used and (2) the number of uses that can be made of it.

According to the Number of Times Capital Can Be Used.—It is a well-known fact that some forms of capital cannot be used more than once in the same operation, while other forms can be used over and over again. The ink used to print this book has been used once and cannot be used again. The oil which is burned to make power or heat can be used only once for this purpose. After the single use in each



Courtesy of The Bureau of American Ethnology

PRIMITIVE INDUSTRY—These Navaho Indians are weaving blankets and belts. All the work is done by hand; very little capital is needed. No factories are necessary. Why would it not be practical to make these rugs under capitalistic production methods?

case, the ink and oil exist no longer. Capital that is used up after one application is called circulating capital.

On the other hand, some capital exists in a more enduring form and can be used over and over again. The surgeon and the dentist use their instruments again and again; mechanics use their tools day after day; machines are operated over a long period of years; factory and office buildings serve their purposes for a long time. Delivery trucks and busses perform for many miles before they are discarded. These are examples of what is called *fixed* capital. Fixed capital is capital that can be used many times in producing goods.

All forms of fixed capital do not last the same length of time; there are varying degrees of durability. A steel hammer, for example, lasts indefinitely. A typewriter lasts a long time, but it finally wears out.

According to the Number of Uses Made of Capital.—Some capital can be used for several purposes while other forms can be used only



Kravitt from Frederic Lewis

SPECIALIZED CAPITAL—Theater buildings, equipment, and machinery are capital employed in a specialized way. You can see that the reconversion of a theater into any other type of business establishment would be an expensive enterprise.

for a special purpose or for relatively few purposes. Many city buildings, for example, have a variety of uses; they may contain stores, offices, waiting rooms, or storage vaults. Similarly, wool can be used for coats, dresses, neckties, and blankets. Leather, likewise, is used for shoes, belts, coats, straps, and many other things. These are examples of the free use of capital. Free capital is capital that can be used for several purposes or by several industries.

In your community there are probably many buildings each of which can be used for only one purpose and few of which can easily and cheaply be changed to other uses. A greenhouse, for example, has one special use and cannot serve any other purpose. There are also some machines each of which can be used for only one purpose. Examples are machines used in the United States mints, certain types of printing presses, and machines which stamp out fenders for automobiles. Specialized capital is capital that is adapted to only one use or to very few uses.

Although both free capital and specialized capital are needed in industry, it is sometimes a disadvantage to have too much specialized capital. Free capital can be adjusted easily to changes in demand, but this is rarely true of specialized capital. This was illustrated when we were preparing for the Second World War. When the demand arose for more machinery to be used to make munitions and other articles needed for war, factories that were equipped with specialized machinery were at a disadvantage in changing over and much time was lost. Moreover, when the demand for things being made by a specialized machine stops, the owner is left with nothing to do. The expense of changing to other machinery might be too great for him to undertake.

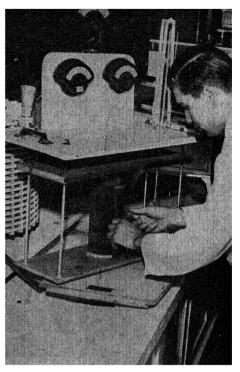
For What Is a Replacement or Depreciation Fund Used?—Because machines wear out or become out of date, manufacturers must provide for this possibility. Old machines have to be replaced with new ones. It is not only machinery that has to be replaced. Buildings also get out of repair, factories become out of date, and tools have to be replaced frequently; trucks get damaged and wear out. Because they are circulating capital and not fixed capital, raw materials must be replenished even more frequently. Taxes and insurance must be paid at regular intervals. It would never do to wait until these things require attention and trust that the money will be available to provide for them. The wise businessman makes provisions for these things continually by setting aside regularly what is known as a replacement or depreciation fund; it is ready when the need arises.

What Is Capitalistic Production?—We have already stated that modern methods of production vary greatly from the methods used one hundred years or more ago. Then small factories were owned by one or a few individuals, who used few machines and employed only a small working force. Goods were made to order and in great variety; markets were local. There was no need for large amounts of capital goods or huge capital funds.

Today, however, production is more complex and indirect. It is a roundabout process in which many steps are necessary before goods are ready for consumers. Before a refrigerator can be ready for use in your home, for example, the manufacturer must procure the necessary money and enlist the aid of others in his business; he must obtain land, build his factory, install machinery and tools, hire workers, buy raw materials, provide transportation, build the refrigerators, advertise them, and sell them. In some cases certain tools and machines

must be built before any products can be turned out. This involves many factors and a long period of preparation. Now you see why modern industry is called "indirect" and why it is a roundabout process. This method of production is also called "capitalistic" because so much capital of all kinds is needed for its operation. It is commonly spoken of as "big business"

How Do You Identify Big Business?—One hundred years ago most of the factories were small affairs operating with little capital. As the country grew, as means of transportation and communication improved and increased, and as power developed, factories began to expand and to turn out goods in greater quantities. This required larger amounts of capital, which was obtained from thousands of people all over the country; now the industries are owned by thousands of people instead of by a few. Many more



Courtesy of R. H. Macy & Co.

STANDARDIZED PRODUCTS—This chemist in the bureau of standards of a department store is giving the "warmth" test to some woolen cloth. Cold air is run through cylinders covered with the cloth. The temperature of a thermometer on the outside of the cylinder, protected by the cloth, is compared with the known temperature of the cold air.

workers are required, and more modern machinery is installed. The system of division of labor has been introduced, and highly paid executives are employed. These are not always owners as had formerly been the case.

The growth in the size of industries has been accompanied by other changes. Under the simpler forms of manufacture, goods were produced on order. This meant that machines and workers were often idle. The modern manufacturer cannot afford to follow this practice. He does not wait until orders are placed before starting production. He produces the goods and takes a chance that they will be sold. Of course he does not take a very great chance because, with the highly

developed methods of advertising and selling, he is almost sure to find a market for his goods. Goods are now produced in anticipation of demand and not in response to demand.

Furthermore, goods are produced according to a definite standard. The simpler methods of production turned out a great variety of goods, but they were not standardized. They did not need to be. But today this would not do at all. Because modern factories operate under a system of division of labor and with a great amount of machinery, they must be kept in operation or overhead expenses will eat up the profits. It would not be profitable for large industries to manufacture goods which were not standardized. Thus all articles must be alike, and all must meet a definite standard.

This standardization is advantageous to producers because it enables them to reduce the unit cost of production and to keep men and machinery occupied constantly. It is also advantageous to consumers because they can buy goods at a lower price and can be sure they are getting what they order. This is true of many items in daily use from automobile parts to articles of food.

What Advantages Come from Capitalistic Production?—Capitalistic production is now such a prominent and permanent feature of our life that it is worth while to examine its advantages and disadvantages. Among the advantages claimed are the following:

Producers Can Save by Buying in Large Quantities.—An industry that is producing several hundred refrigerators a week or several thousand automobiles a day uses up large quantities of raw materials. Some manufacturers own or control the sources of their raw materials. Those who must buy these materials find that they save money by buying in huge quantities. They save not only in cost of materials but also in transportation charges because it costs less to ship in carload lots than in smaller quantities.

Waste Products Can Be Used to Good Advantage.—In all industries there are some things, called by-products, which cannot be used in the main product. They are leftovers, which accumulate rapidly in large industries. Unless some way can be found to use them, there is a tremendous loss. Small producers cannot afford the expense of turning these waste products into useful articles. But the larger industries have made a scientific study of the problem and are able to use practically everything; nothing now is wasted. Otherwise useless products and

formerly discarded parts are made into by-products which are sold at a profit. Many of these products are sold under trade names, such as Vaseline, margarine, Nylon, and Cellophane. Many plastics were originally by-products; they are now main products.

New Products and Processes Can Be Developed.—With huge funds which are used for experimental purposes, big industries build and equip laboratories in which chemists and other experts in engineering analyze materials and develop new products and new processes of manufacture. Many of the newer types of food products are the results of such experiments. Much of the progress made by such industries as General Electric, Ford, du Pont and others is due to the industrial research carried on by these corporations.

There Is Much Saving in the Use of Capital.—When there are many small individual factories scattered over the country competing with one another, there is bound to be duplication of factory buildings and machinery. The supervisory and clerical forces must be duplicated in each plant. Overhead costs are increased. When there is one large industry buying large quantities of raw materials to be shipped to one location instead of to several; when one office force takes care of all the work instead of several office forces with their files and equipment; when fewer buildings have to be maintained and all the machinery can be under one management, there is much economy in the use of capital. Machines can be kept busy all the time in a large plant and more economies are possible.

What Disadvantages Come from Capitalistic Production?—No productive enterprise, large or small, is free from disadvantages. Large-scale production has its disadvantages.

Business May Become Too Large to Manage Efficiently.—When factories were smaller and problems were fewer, it was not difficult to find men who could manage industry efficiently because they understood the business from top to bottom. As industries grew larger, it became harder for any one man to know all about even one entire industry; responsibilities had to be delegated to subordinates. Each delegation of authority, each addition of a department, makes it harder to supervise and to coordinate various departments. When an industry establishes branches and plants in other locations, these problems are increased. It is becoming still more difficult to find a single executive who is capable of handling the entire business effi-

ciently. Thus it is possible for an industry to expand to such an extent that it may become unwieldy.

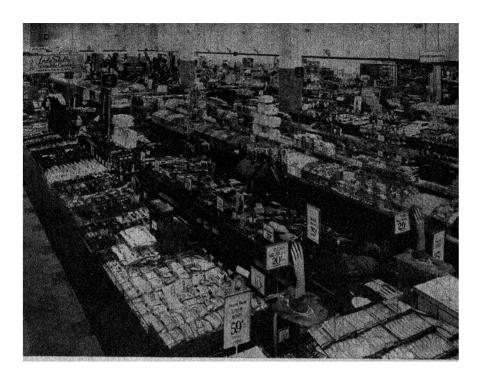
Labor Problems Become More Serious.—In the small factory the owner and the workers frequently worked side by side. The owners knew the workers and their problems, and the workers had an understanding of the problems faced by the owner. There was a close relationship which made for fewer labor problems and less loss from strikes. In a plant where thousands of workers are employed, where the tasks are minor ones, and where the workers are scattered through various departments of the plant, many serious problems arise. It is impossible for the employees in such a plant to become acquainted with all their bosses because there are too many of them. The worker knows that he obtained his job through some foreman or through the personnel department. In such an organization workers cannot feel a personal interest in the business or a pride in its product. In many cases the worker is only a number who punches a time clock several times a day. His employers frequently have little personal interest in him or his problems. This has caused an unhealthy attitude and much friction. Strikes are started and time is lost from production. As a result both employees and employers suffer.

How Do Consumers Benefit from Capitalistic Production?—The advantages of big business listed above are chiefly gains for the owners or producers. What benefits do consumers derive from this type of production?

They Obtain Goods at Lower Prices.—Through the many economies made possible in large-scale production, it has become possible to produce goods at a much lower unit cost. This reduction in production costs has been passed along to consumers, thus enabling them to obtain more goods at lower prices.

There Is a Greater Variety of Goods from Which to Choose.—The small factory was restricted in the variety and quantity of goods it produced. Through the experiments carried on by large corporations, many new articles have been produced and consumers now have a wider choice of goods from which to satisfy their wants.

Goods Are Standardized and of Better Quality.—Capitalistic production results in standardized goods. These standardized goods relieve the consumer of the problem of investigation for which he is not fitted.



Courtesy of F. W. Woolworth Co.

VARIETY OF GOODS—Big business has made possible a great variety of goods. This picture will give you an idea of the many goods available at a 5- and 10-cent store from which the consumer may choose.

In the case of most goods he is getting quality and can depend upon the article being what he wants. In some cases, however, standardization has meant a leveling downward of grade of material, for quality has been sacrificed to quantity.

What Chance Has the Small Producer?—From what has been said about big business it should not be inferred that all businesses in the United States are on a large scale and that small producers and little businessmen are on the way out. Observation will prove to you that this is not true. When you walk home from school, take note of the business places you pass. Many of them are owned and managed by one person or by a partnership. Perhaps there are some small industries in your community employing only a few workers and operating with a small amount of capital. Most of these industries are prosperous and are filling a need in the community. Although, in terms of capital funds, number of employees, and quantity of goods produced, large-scale industries head the list, there are still thousands of small businesses in this country.

Most farmers own and operate their farms and conduct a small-scale business. Many businesses are not suited to large-scale methods. There are many small shops producing toys, furniture, shoes, hosiery, hardware, jewelry, and clothing. Beauty shops, barber shops, news-stands, ice cream and food shops, bookstores, and many drugstores are small-scale businesses which find a useful place in our economic life. The small businessman with little capital is still needed and probably will always exist. However, during a total war when it becomes necessary to restrict the production and sale of many articles, the small business is in a serious position and its very existence is threatened.

Summary.—Capital is the result of the cooperation of man and nature. In economics it is defined as any product of past labor used for further production. Capital in the form of money used to operate a business is known as capital funds, while other forms of capital are called capital goods. Fixed capital can be used over and over again, while circulating capital disappears after one or a few uses. Free capital can be used for many purposes or in many different industries; specialized capital has only one or a few uses or is used in only one or a few industries.

Industries are using capital goods continuously; circulating capital must be replenished all the time and even fixed capital needs to be replaced from time to time. Buildings and machinery slowly wear out or suddenly become out of date. Wise producers lay aside a sum of money each year to provide for replacements and depreciation. This fund is called a replacement or depreciation fund.

Although there are still many industries operating with small amounts of capital and few workers, most economic goods are produced under more modern methods of large-scale production. Such large-scale industries employ millions of capital funds, thousands of workers, and hundreds of machines. Instead of being produced on a small scale for immediate and local consumption, goods are now manufactured in large quantities in anticipation of demand and are sold in far-distant world markets. It takes quite a while now to establish an industry and to produce a finished product. Machines are made to produce machines which provide our goods. This is called indirect or roundabout production. This mechanization of production results in a standardization of product.

Indirect or capitalistic production has advantages for owners and for consumers. Producers are able to make many economies and to use by-products profitably. Consumers save money by buying goods at a lower price; they have a wider choice of goods; they generally get standard goods of good quality. The disadvantages are that the business may become unwieldly and too large to manage efficiently; labor problems are more serious owing to the impersonal relations existing between employers and employees.

The small businessman has not been eliminated entirely by big industries. There is still need for small businesses, which may continue to exist if they render useful services not performed by big business. Finally, all industries cannot be operated on a large scale.

# Questions to Test Your Knowledge

- 1. Define capital.
- 2. Name several articles that would be capital according to your definition
- 3. Name some articles that would not be capital. Why are they not capital?
- 4. Distinguish between capital funds and capital goods.
- 5. Name the steps necessary if capital is to be formed.
- 6. What are the two classifications of capital goods?
- 7. Define and give an example of circulating capital.
- 8. What are fixed capital goods? Give several examples.
- 9. How is free capital distinguished from specialized capital?
- 10. Explain what is meant by capitalistic production.
- 11. State several characteristics of capitalistic production.
- 12. List the advantages and disadvantages of capitalistic production.
- 13. What benefits do consumers derive from capitalistic production?
- 14. Why will small producers always be needed?

#### Questions for Discussion and Application

- 1. Discuss the various meanings of capital.
- 2. Discuss the significance of saving in the formation of capital.
- 3. Explain why hoarded money is not capital.
- 4. It is said that modern production is dependent upon a continuous flow of capital funds. Explain this statement.
- 5. Discuss the advantages of large-scale production over the direct method of production. Would you question any of these advantages? Does the direct method have any advantages over large-scale production?

- 6. Show by several examples that capitalistic production has been of great benefit to consumers.
- 7. Discuss the gains and losses to consumers from the standardization of goods.

#### Floor Talks and Written Reports

- 1. Significance of savings in modern society.
- 2. Large-scale farming.
- 3. Effects of big business on workers.

#### Topic for Debate

RESOLVED, That large industrial units do more harm to society than they do good.

#### For Further Information

Bogart, E. L., "Economic History of the American People," Parts II, III. Building America, "Chemistry at Work," Vol. III, No. 5.

Faulkner, H. U., "American Economic History," Chaps. 13, 20, 21.

Gemmill, P. F., "Fundamentals of Economics," Chap. VII.

Taylor, H., and Others, "Main Currents in Modern Economic Life," Chaps. 13, 15.

#### PROBLEM 9

#### Has Big Business Become Too Big?

Although large-scale production is acknowledged to have brought many important advantages to society in general, there are some who feel that the advantages are not so great as claimed. These critics are concerned chiefly with the changes that big business has made in labor relations. They claim that the gains of producers and of consumers have been made at the expense of those who produce the goods. Among the criticisms are the following: Workers are no longer skilled craftsmen as they were when goods were produced in a less indirect fashion; the personal relationship between employers and workers has given way to a view which regards the workers as agencies which add to the output and to the profits of the business but which have no personal standing. The claim is also made that many machinemade products are not of so good quality and workmanship as those made by hand. Workers who operate machines and make products from blueprints have no pride in what they produce and care little about the quality of the goods. It is further claimed that large-scale production has caused periodic unemployment of large numbers of workers and the retirement of workers from employment while they are still in their prime.

Although these critics would not eliminate all large-scale activities, they suggest that it might be better for workers and for society if there were more industries operated with less machinery and more handwork, thus giving steady employment to workers.

- 1. If this plan were adopted, what effect would it have on the amount of goods produced? on the quality of the goods so produced?
- 2. What industries could be operated in the manner suggested?
- 3. What type of workers would be likely to find employment?
- 4. Would this give employment to all who desire it?
- 5. What effect would this change have upon prices of goods made in these industries?
- 6. What disadvantages might result from this arrangement?
- 7. Would the standard of living of the people be changed in any way? How?
- 8. Would there be any real advantages to workers in this plan?
- 9. Would you favor the change? Give your reasons.

# Chapter VIII

# How Business Is Organized for Production

#### Aims of This Chapter:

To discover the functions performed by management.

To examine the individual proprietorship form of business.

To learn the advantages and disadvantages of partnerships.

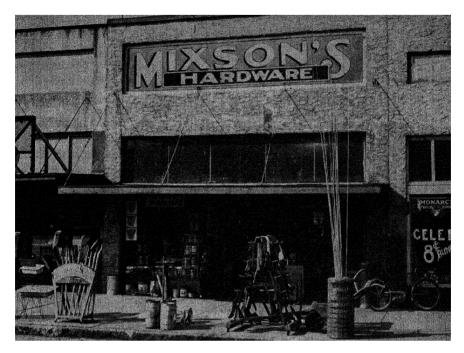
To find out how corporations are formed and financed.

To see why corporations are superior to other forms of business.

To understand different types of bonds and stocks.

Now that you have learned something about three of the factors of production—natural resources, labor, and capital—you are ready to examine the fourth factor, business management. Although the three factors are important, no one of them acting alone could produce the goods we need today. These three factors might be likened to a team of powerful horses ready and willing to pull a heavy load but unable to do so because they lack control and direction. With proper control and direction they can do all that is asked of them. The factor that supplies the needed control and direction is known as "management." It will be discussed in this chapter.

What Functions Are Performed by Management?—In a sense it may be said that management represents the brains of the process of production. It is the factor that plans, coordinates, controls, and directs the entire process. In exercising these functions the business manager assumes many risks and bears a heavy responsibility. It is the function of the business manager to estimate as accurately as possible what the demands of consumers will be because goods are now produced before demands are known. If he fails to estimate correctly, there may be too many goods produced at one time or too



Courtesy of Library of Congress

INDIVIDUAL PROPRIETORSHIP—The proprietor of this hardware store displays his wares prominently on the sidewalk. He is free to develop his own advertising ideas, select his stock, deal with whom he chooses, retain the profits. Compare his privileges and responsibilities with those of a member of a partnership.

few at another. Likewise the wrong kind of goods may be produced. When these situations arise, the manager must provide ways of disposing of the goods or of producing more goods of the type wanted. He must organize different types of business to produce and sell the goods; he must inform the public where and how these goods can be obtained. He must see that sufficient funds are provided to carry on production, must organize markets, and manage the business after it has begun operations. In organizing business he has a choice of three types: (1) the individual proprietorship, (2) the partnership, and (3) the corporation

Some Prefer to Own a Business Alone.—This is the type of business organization in which all the responsibilities are assumed by one individual. It is the commonest type of business activity in the United States. It is estimated that about one-half of all farms are owned and operated by individual proprietors. Most of the small retail businesses are conducted by individual owners. It is well adapted to those businesses which require little capital, have a simple organization, and call for personal management and supervision.

Advantages.—The business that is personally owned and operated has certain advantages.

It is easily organized and dissolved.—When an individual wishes to establish a business of his own, he does not need to get permission from the state or anyone else to do so. No charter is necessary and no articles of agreement need to be drawn up. The individual owner knows what he wants to do and does it. Likewise, when he wishes to give up the business, he may do so without any special legal action.

The owner is independent.—He is his own boss. There are no partners, stockholders, or directors to tell him what to do or what not to do. No one can interfere with him in the conduct of his business. He may operate it as he pleases, deal with whom he chooses, make his own agreements, and adopt any method of dealing with his customers that satisfies him and them. Furthermore, he does not have to share his profits with anyone.

His relations with employees and customers are personal.—The owner of such a business does not have many employees. Those whom he does employ are his personal choices and he knows them and their problems. These employees also become familiar with the problems of their employer. Thus a close personal relationship exists. Moreover, the individual owner is a local man and his business is local. The owner knows his customers personally and can cater to their individual needs. It is a simple matter for him to change his methods of operation or the nature of his goods to suit the demands of his customers.

Disadvantages.—However important these advantages may be, there are certain serious disadvantages to the individual proprietorship.

Capital is limited.—The amount of capital used in the individual business is limited to what the owner himself can furnish or borrow. If the owner has no desire to expand his business and is satisfied to operate in a limited field, this may be no handicap. But if the owner believes that he can make greater profits by expanding his business, he may find difficulty in raising additional capital. His inability to obtain more funds will restrict his chances for more profits.

Financial responsibility is unlimited.—The owner of a business must assume all the risks and is legally responsible for all the debts of the business. He may lose not only what he has invested in the business itself but also any personal or private property that he may have

accumulated. The only limit to the loss is that set by the bankruptcy laws of the particular state in which he resides and conducts his business. These exemptions are not very large.

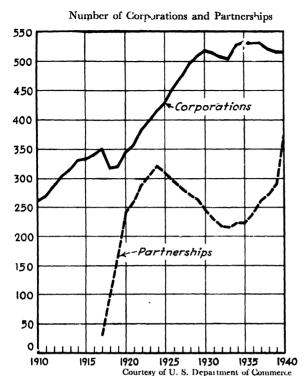
Able management is often lacking.—A small, individually owned business can succeed only to the extent of the ability of the owner. In spite of this fact, many seem to think that anyone can operate a small business. Such a business is easy to start. To many it may appear to require little ability and only a small amount of capital. As a result of this attitude many start a business who do not know their jobs. This means that many fail. It is estimated that about 15 per cent of retail businesses fail every year.

Life of the business is limited.—The existence of the business is dependent upon the health and life of the owner. If the owner dies, the business usually comes to an end unless arrangements have been made for someone else to take it over.

Some Prefer to Share with Partners.—This type of business grows out of the individual proprietorship. When the personally owned business reaches a point where more capital and additional ability are desirable, the owner often seeks another person to share the business with him. Thus a partnership comes into being. A partnership is an association of two or more persons who assume jointly and severally the responsibilities of the business. This means that there are several persons acting as owners and managers instead of just one. Partnerships are formed by drawing up agreements which may be in any form and may include almost anything the partners wish.

Partners are of three kinds: general, silent, and limited. General partners are those who have full voice in the management and assume complete responsibility for the obligations of the business. Silent partners are those whose activities are restricted to sharing the gains and losses; they take no part in the active management. Limited partners are those whose liability is limited to the amount they have invested in the business, so long as they take no active part in the business.

The partners make their own agreements as to how profits are to be shared and how activities are to be delegated. It is not unusual for some partners to invest more capital than others. But no matter what arrangements the partners may choose to make among themselves, each general partner is personally responsible for all the obligations



Corporations increased rapidly after 1910; partnerships teached a peak in 1923, and then dropped. In 1936 there were about 540,000 corporations, 240,000 partnerships, and at least 1,220,000 one-man-owned businesses (not shown).

of the partnership to outsiders. The only exceptions are in those states that permit limited partnerships, which must be stated in the articles of partnership.

Partnerships are especially suited to those activities which call for a diversity of talents and which need more capital than one individual can command. Thus we find partnerships among professional people, such as lawyers, doctors, dentists, architects, and accountants.

What Are the Advantages of Partnerships?—Several advantages are claimed for partnerships.

They Are Easily Established.—Although there is a little more formality in establishing a partnership than there is in starting a personally owned business, the procedure is still quite simple. No charter is needed. All that is necessary is that the partners draw up an agreement among themselves. If it is a limited partnership, it is necessary to register with the state.

They Can Command More Ability.—A partnership offers opportunities for persons of differing abilities to enter a business. In fact it is the form best adapted to organizations where personal efforts or services are the important factors. This is why it is so popular among the professions. Each partner attends to that phase of the business for which he is best suited. Thus a partnership is not dependent upon the wisdom and judgment of one man.

Risks Are Shared. The individual owner assumes all the risks of the business. In partnerships these risks are shared by all the partners.

They Can Command More Capital.—Because the number of those who may join a partnership is unlimited, there is an abundant source of capital available. Several men can invest more money in a business than one man; banks are more willing to make loans to a partnership on this account.

They Are Relatively Free from State Regulations.—Partnerships are not so likely to be restricted and regulated as are corporations. They are also free from many heavy taxes that are imposed upon corporations.

**Partnerships Have Serious Disadvantages.**—The disadvantages of a partnership are sometimes of a serious nature.

Personal Liability Is Unlimited.—A general partner is personally liable for all the mistakes and errors in business judgment made by his partners. If he happens to have some private property in addition to what he has invested in the firm, he may be obliged to give this up in case the partnership fails and it is needed to help settle the debts of the firm. This is one reason why many men hesitate to enter a partnership.

Life of Business Is Uncertain.—The partnership is a highly personal organization. Whatever happens to one member affects all the others. If a partner dies, withdraws from the firm, or goes into bankruptcy because of debts contracted outside the partnership, the firm may be dissolved. This will happen unless the partners have provided for this contingency by making arrangements to take care of it. Again, differences of opinion may arise among the partners regarding matters of finance or business policies. Such disagreements tend to create friction which may interfere with the smooth running of the firm and may eventually bring about its dissolution.

Profits Must Be Shared.—The individual owner gets all the profits himself and shares with no one else. But if he takes a partner, he must share the profits with this partner according to the agreement. When there are several partners, the profits may not be sufficient to allow any one of them to obtain a share large enough to warrant the risks taken.

What Is a Limited Partnership?—A limited partnership is one in which several of the partners have unlimited personal liability for debts but one or more partners have their liability limited to the amount they have invested in the business. This type of partnership must be registered with the proper state authority. It is not permitted in all states. Partners with limited liability become fully liable if they assume an active part in the business.

Limited partnerships have two advantages: (1) The business does not have to dissolve nor does a new agreement have to be drawn up when a partner dies because the heirs of the deceased partner can be admitted as limited partners. (2) The limited partnership avoids the heavy taxes that are imposed upon corporations by some states.

What Is a Corporation?—A corporation has been defined as an association of individuals, called stockholders, who are authorized by a charter granted by the state to carry on a specified business. A corporation is a legal person entirely separate from its members. In other words it is an artificial person created by the state. As such, the corporation may do practically anything a person may do. It may make contracts, borrow and lend money, buy and sell property, sue and be sued. It may do all these things in its name as a corporation without in any way involving its officers or stockholders as individuals.

Why Is a Corporation Important Today?—The corporation is not a new form of business organization; it has existed for several hundred years. But it was formerly less important and less common than today. The corporation is now the leading form of business organization throughout the world. It is found especially in manufacture, transportation, communication, public utilities, and large-scale enterprises. In the United States at the present time there are about 500,000 corporations, which account for about 25 per cent of all the business enterprises of the country.

The importance of corporations is further shown by the number of people who have invested in the stocks and bonds of these corporations. Two of our largest corporations may be cited as examples: the American Telephone and Telegraph Company has over 675,000 individual stockholders; the United States Steel Corporation has about 240,000 individual stockholders. Some stockholders own only a few shares, while others own hundreds of shares. Savings banks and insurance companies also are heavy investors in the securities of corporations; this gives corporations added importance.

# PICTURE STORY OF A CORPORATION



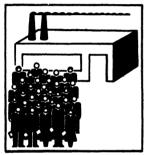
. A man makes a profitable invention. He does not have enough money to build a factory and pay wages



2. He presents this idea to some people who have access to money



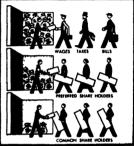
3 In exchange for their money these peo ple become part-owners (stockholders) of the new company.



4. These are the owners (stockholders) of the company.



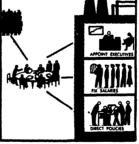
5. All told there are about twice as many stockholders as there are workers in your company.



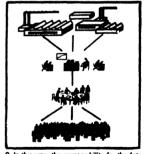
wages, taxes and bills first, From th mainder some of the owners (the ferred" ones) get a fixed amount; what is left goes to the common stockholders.



To make sure that the company is run in their interest, the common stockholders take a hand in the business.



8. The Board of Directors elected by the 9. In this way, the responsibility for the fate stockholders appoints the executives, fixes salaries, and directs the policies of the company.



of the company rests on the owners (stockholders)

PICTOGRAPH CORPORATION , 142 Lexington Ave , N. Y., for the Monsanto Chemical Company

How Are Corporations Formed?—Every state has laws pertaining to the establishment and regulation of corporations. Most of these states require at least three persons to organize a corporation. Any group of three or more persons who wish to organize a corporation may submit articles of incorporation to the proper state official.

As soon as the application has been approved and filed, the charter is granted.

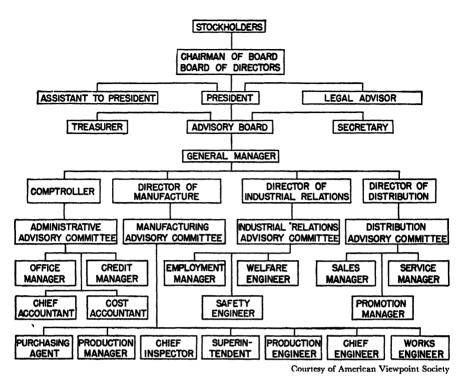
The charter is necessary before any corporation may do business legally. It gives the name of the corporation, its purposes, the place where the business is to be carried on, the names and addresses of the directors, the kinds and amount of capital stock it may issue, the length of time the charter shall be in effect, and several minor details. After the charter has been received, the stockholders adopt a set of bylaws and approve the choice of directors to manage the business. Most corporation charters are granted by the states, but the Federal government grants charters to Federal Reserve banks, national banks, Federal savings and loan associations, some railroads, credit unions, and many government corporations.

How Is a Corporation Governed?—The owners of a corporation are its stockholders. Some stockholders own thousands of shares of stock, although the great majority of them own from one to ten shares. Each stockholder is entitled to as many votes as he has shares of stock. But since most stockholders care little about a voice in management and seldom if ever attend meetings or vote, some corporations now restrict the right to vote to a single class of stockholders. Stockholders, as a rule, are interested chiefly in the return they receive from their shares and the possibility of their increase in value.

At the annual meeting the stockholders elect a board of directors from among their own number. This board has complete charge of the affairs of the corporation. It determines all policies and chooses the active officers of the corporation, who are responsible to the board, which decides whether or not corporate earnings justify dividends and, if so, what dividends shall be paid.

A Corporation Has Many Advantages.—The corporation is the outstanding form of business organization because of certain advantages which it possesses.

Liability of Owners Is Limited.—In the individual proprietorship and partnership the financial liability of the owners is unlimited. This has been a serious disadvantage of both these types of business. In the corporation the liability of the owners is limited to the amount they invest in the business. The only exceptions to this rule are some state banks in which the stockholders have what is called "double liability."



A graph to show the organization of a corporation.

It Is a Stable Form of Business.—As the lives of the individual enterprise and of the partnership are uncertain, many things may happen to put an end to them. The life of the corporation, however, is not dependent upon the health, personality, or financial condition of its individual owners. If a stockholder dies, the corporation is not affected. Nothing that happens to a stockholder affects the corporation. The life of the corporation is limited only by the state granting the charter. Since it is quite easy to have a charter renewed, the corporation enjoys practically a perpetual existence. Of course, if a corporation violates its charter provisions or fails to meet its obligations to creditors, it can be terminated.

Its Ownership Is Easily Transferred.—Any owner of shares in a corporation may dispose of them quickly because exchanges exist where stock can be sold readily. Likewise, if one wishes to increase his ownership, it is equally convenient to purchase shares of stock.

Large Capital.—The amount of capital that an individual proprietor can accumulate for his business is limited. Even in a partnership, the amount of capital that can be raised is limited. The corporation, however, can raise almost indefinite sums of capital by selling shares of ownership to thousands of people or by borrowing through the sale of bonds. Through the issue of bonds, preferred stock, and common stock the corporation can appeal to all types of investors and thus have a large source of supply for its capital needs.

Corporations Have Their Disadvantages.—While the corporation has definite advantages over other types of businesses, it has disadvantages too.

They Are Subject to Heavy Taxation.—Corporations are subject to a greater number of taxes than are other forms of business. Moreover, they are taxed by both the state and the national government. They must pay heavy income taxes, numerous franchise taxes, a high surplus-profits tax, and many minor taxes that eat into profits.

They Are Subject to Government Supervision.—Corporations derive their right to exist from the state, and the state in turn exercises the right to supervise and regulate them. All types of business are now subject to government regulation of one kind or another, but corporations must submit to greater regulation than any of the others. These restrictions on corporations have been imposed to restrain them from exploiting labor, consumers, and investors. The recent Federal laws regarding wages and hours, labor relations, and issuance of securities, have imposed strict limitations upon the activities of corporations.

Ownership and Control Are Separated.—Corporations today are controlled by a few individuals. This is made possible because the many small owners are so far removed from any active interest or part in the enterprise. This is sometimes referred to as absentee ownership.

How Does a Corporation Get Its Capital?—There are two common ways by which a corporation may obtain the capital it needs to operate its business. It may sell shares of ownership called "stock," or it may borrow the funds by selling bonds.

When it sells stock, the evidence of ownership is a certificate indicating the number of shares the possessor owns. If the corporation borrows funds, the usual procedure is to issue bonds which become obligations binding the corporation to pay back the borrowed money at a specified time and meanwhile to pay a fixed rate of interest. Since bonds represent loans, bondholders become creditors. The return

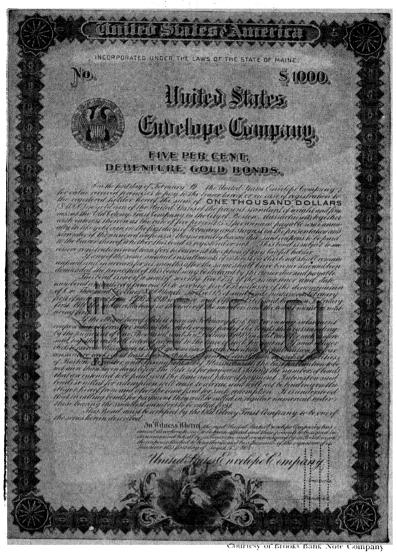
which is paid to the bondholders is called "interest," while the share of earnings paid to stockholders is called a "dividend." Both stocks and bonds are securities. Bondholders have a prior claim upon the assets of the corporation and also upon its earnings. The interest on bonds must be paid before any dividends can be paid to stockholders. If a corporation fails to meet its obligations, the creditors may foreclose the business. The bondholder has a favored position in the financial structure of a corporation, takes a smaller risk, and gets a definite return. But he has no voice in the management of the business.

What Are Bonds?—A bond of any sort is a written promise to pay a definite sum of money at a specified time and at a fixed rate of interest. There are many different kinds of bonds used by corporations in order to appeal to as wide a group of investors as possible. We shall consider only the two commonest types: mortgage bonds and debenture bonds.

Mortgage Bonds.—These are promises to pay which are backed by a claim to some definite property of the corporation, such as land, buildings, or machinery. These bonds are of several types depending upon the nature of the claim. If they give a first claim, they are called "first-mortgage" bonds. Then there are second-, third-, etc., mortgage bonds, the holders of which must wait until all prior claims have been satisfied before they obtain anything. As the holders of these bonds assume a greater risk, they are usually paid a higher rate of interest. Owners of mortgage bonds have the first claim to the assets of the corporation if it fails to keep its agreements or if it goes out of business.

Debenture Bonds.—These are promises to pay which are not backed by a claim to any specific property of the issuer. Their security lies in the earning power of the corporation, its credit standing, and the faith the investor has in the issuer. Most government bonds are of this type. They are sometimes called "income" bonds.

How Do Coupon Bonds Differ from Registered Bonds?—These terms refer to the manner in which the interest on bonds is paid. Coupon bonds are those which have attached to them small certificates representing the interest which will be paid at the time specified. The owner of such a bond merely needs to clip the coupon on the proper date and cash it. If the coupons are lost, they are difficult to reclaim. If the bond is lost, it may be somewhat difficult to trace.



DEBENTURE BOND—This is the certificate part of a bond. It contains all the terms and conditions under which the bond is sold. What is a debenture bond? How does it differ from a mortgage bond?

Registered bonds contain no coupons. The name and address of the owner are listed on the books of the corporation, and he receives his interest in the form of a check on the specified date. If a registered bond is lost, it is easier to trace and the owner is assured that his interest will come to him.

How Do Stocks Differ from Bonds?—A large amount of the capital used by corporations is raised by selling shares of ownership to the public. These shares are called "stock" and differ from bonds in that the corporation does not agree to pay back to stockholders the money they invest, because stockholders are not creditors. Stock may be of two kinds: (1) common and (2) preferred.

Common Stock.—This is the kind of stock that most nearly represents ownership. The owners of it are the last ones paid in case a corporation fails and then only if there is enough left to pay them something. Holders of common stock assume the greatest risk, and so expect to get the greatest profits if the enterprise is successful. They usually have a voice in the management of the corporation, even though they may not express it.

Preferred Stock.—This kind of stock resembles a bond in that it carries a definite rate of return. However, the return is not guaranteed, and the owners are among the last to be paid off in case the corporation fails. Preferred stock gets its name from the fact that it has certain preferences over common stock. Owners of preferred stock receive their dividends before the common stockholders and are paid before common stockholders in case of failure of the corporation. Preferred stockholders usually have no voice in the management. There are two kinds of preferred stock: cumulative and participating.

Cumulative preferred stock is the kind in which the failure to pay dividends in any one period means that they will accumulate as an obligation to be paid later. Until these accumulated dividends have been paid in full, no dividends may be paid on the common stock.

Participating preferred stock is the kind that shares in some way with the common stock in the earnings over and above the rate that has been specified. For example, if a person owns 7 per cent participating preferred stock, he will receive the 7 per cent dividend. Then, after the common stock has been paid a good dividend, he will share equally with the owners of the common stock in any further division.

What Are Dividends?—These are payments from profits made to the owners of the corporation, the stockholders. Preferred stockholders receive a designated rate of return, but common stockholders never know just what they will get or if and when they may get dividends. No dividends on stock are guaranteed, nor is there any assurance that all the earnings will be paid out as dividends. Dividend



STOCK CERTIFICATE—A stock certificate represents part ownership in a corporation. This is a common stock certificate with a par value of \$25 Is there any promise contained in this certificate? How may it be transferred?

policies depend upon the vote of the directors; dividend possibilities depend on earnings.

Dividends may be paid in *cash* or in additional shares of stock. The latter is called a *stock* dividend. For example, if the corporation decides to declare a stock dividend, it may give an additional share of stock for each five shares already owned.

What Terms Are Used Relative to the Value of Stock?—There are several terms relating to the value of stock with which you should become familiar.

Par Value and No Par Value.—These are terms used to designate whether or not the stock has a face value. Today par value really means very little. It is merely the value printed on the stock certificate. When the stock is first issued, it may be sold at its par value. It does not mean that the stock will ever be worth this amount on the books or in the market. Par value is commonly \$100, but it may be any fractional part of this amount. No par value means that there is no

value printed on the certificate, and the corporation that issues it does not estimate any value for it Many corporations now issue stock with no par value.

Book Value.—This is the amount that each share would be worth if the corporation were dissolved and its assets sold. It is obtained by dividing the net assets (total assets minus total liabilities) by the number of shares in the hands of the public. For example, if the net assets of a corporation are 25 million dollars and the number of shares outstanding are a million, the book value of each share is \$25.

Market Value.—'This is what the stock is worth from day to day in the markets where securities are bought and sold. It is the value that interests most stockholders because it determines how much they can get for their shares if they wish to sell them or how much they must pay if they wish to buy more. It may be more or less than the par value or the book value.

Summary.—Business management is the factor of production that controls and directs the other factors. Management provides ways of producing and disposing of goods and of financing enterprises. In conducting a business there are three forms of organization that may be used: the individual proprietorship, the partnership, and the corporation. The individual proprietorship and the partnership are easily established, but they may be handicapped by lack of capital and by the fact that their existence is dependent upon the life of the owners. They avoid many of the heavy taxes and regulations imposed upon corporations, but they are limited in their fields of activity.

The corporation is an association of individuals, called stock-holders, who are authorized by a charter to carry on a specific business. Corporations may do practically anything a person may do. They are now the leading form of business organization in the United States; they are found especially in manufactures, transportation, communication, and public utilities. Charters are granted by states and by the Federal government to groups of individuals who wish to establish corporations and who comply with regulations.

Corporations obtain their capital by borrowing through the sale of bonds, which are promises to repay the loan, or through the sale of shares of ownership called stock. Bondholders are creditors and have the first claim upon the earnings and assets of the corporation, but they have no voice in its management. Common stockholders are part owners who have a voice in the management, elect the board

of directors, and assume final responsibility for the obligations of the company. Preferred stockholders are also owners but do not usually have a voice in the management.

#### Questions to Test Your Knowledge

- 1. Define business management.
- 2. List several functions performed by management.
- 3. What are the three types of business organization?
- 4. List the advantages and disadvantages of the individual ownership.
- 5. Define a partnership.
- 6. In what ways is a partnership superior to an individual proprietorship?
- 7. How do limited partnerships differ from general partnerships?
- 8. What is a corporation?
- 9. Explain why corporations are important today.
- 10. How is a corporation formed?
- 11. What is contained in the corporation charter?
- 12. State the advantages and disadvantages of corporations.
- 13. How do corporations obtain their working capital?
- 14. Define a bond.
- 15. Distinguish between the two types of bonds.
- 16. What is meant by stock?
- 17. Distinguish between common stock and preferred stock.
- 18. Explain book value, par value, and market value.
- 19. Compare the relationships between bondholders and stockholders.

### Questions for Discussion and Application

- 1. Explain why business management is so important in the process of producing goods.
- 2. Discuss the features of partnerships that cause men to hesitate to enter them.
- 3. Why do corporations sell their shares of ownership to so many people while only a few are allowed to control the business?
- 4. Is there any advantage in having the control of a corporation in the hands of a few? To whose advantage is it? What objections can you offer to this practice?

- 5. Why are bondholders not given a voice in the management of corporations?
- 6. To what class of people does preferred stock appeal? Does the issue of preferred stock impose any special obligations on the corporation?
- 7. List some of the recent regulations that have been imposed upon corporations by the Federal government. Why were these regulations imposed? How can the Federal government regulate corporations that are creatures of the states?
- 8. To what extent do small stockholders have a part in determining the policies of a corporation? Does it make any difference whether the corporation is small or large? Why do so many stockholders take little interest in how the corporation is managed?
- 9. Discuss the reasons why corporations prefer to finance themselves through sales of stock rather than through sales of bonds.

### Floor Talks and Written Reports

- 1. Absentee ownership of corporations.
- 2. Decline in the influence of stockholders.
- 3. How stock exchanges aid production.

### Topic for Debate

RESOLVED, That the establishment and regulation of corporations should be functions of the national government alone.

# For Further Information

Berle, 'A. A., and G. C. Means, "The Modern Corporation and Private Property."

Building America, "Business," Vol. 4, No. 7.

Gemmill, P. F., "Fundamentals of Economics," pp. 78-90.

Kiekhofer, W. H., "Economic Principles, Problems and Policies," pp. 82-138.

Patterson, S. H., and W. K. H. Scholz, "Economic Problems of Modern Life," Chap. II.

Twentieth Century Fund, "Big Business, Its Growth and Its Place."

#### PROBLEM 10

## Choosing a Type of Business

For six years Thomas Harding had conducted a retail grocery business of his own. In this time he had built up a good reputation in his community

and his business showed a profit each year in spite of the competition of a chain store. His customers liked him and preferred to buy from him, but his line of goods was not complete enough to satisfy all their wants. They urged him to expand his business to include all that the chains carried. Harding did not have the money with which to make the changes, but he knew of a friend who might be willing to join him as a partner. Some of his customers suggested that he organize a small corporation, keeping control himself and selling the balance of the stock to the public. Harding was puzzled and did not know what to do. He consulted a lawyer to learn all the possibilities.

- 1. Would you advise him to form a partnership with his friend?
- 2. What advantages might there be in a partnership?
- 3. What disadvantages might result from a partnership?
- 4. What steps would be necessary to form a corporation?
- 5. What advantages would the corporation have over the partnership for Harding?
- 6. Would there be any disadvantages for Harding in the corporation form of business?
- 7. If you were the lawyer consulted, what advise would you offer?

#### PROBLEM 11

### The Problem of Savings

Mr. Brownell makes a good living from his business and is able to provide his family with all their needs and some comforts. But he is sensible enough to know that if he is to do more than provide for the present needs, he must set aside something for emergencies and for the future. You will note from Problem 2 that he has set aside in his budget 18 per cent of his income for this purpose. Part of this goes for life insurance, which is a form of investment; some will be placed in a savings bank as an emergency fund. He wishes to invest the balance in such a way that it will earn a reasonable increase from year to year and still be fairly safe. The problem is to find the best place to invest these small savings.

- 1. What is meant by investing money?
- 2. After studying Chapter VIII, would you advise Mr. Brownell to purchase stock? Give your reasons.
- 3. Make a chart showing the advantages and disadvantages of bonds and stocks as forms of investment.
- 4. Show that insurance is a form of investment.
- 5. Would you advise Mr. Brownell to put his savings in his business to expand it? Why, or why not?
- 6. How would you advise him to invest his surplus savings?

### Part III

# How Goods Are Exchanged

Chapter IX:

THE MECHANISM OF EXCHANGE

Chapter X:

SOME PRINCIPLES OF EXCHANGE

Chapter X1:

MONEY AND WHAT IT DOES

Chapter XII:

**OUR MONETARY SYSTEM** 

Chapter XIII:

THE CHANGING VALUE OF MONEY

Chapter XIV:

CREDIT AND HOW IT IS USED

Chapter XV:

BANKS AND THEIR SERVICES

Chapter XVI:

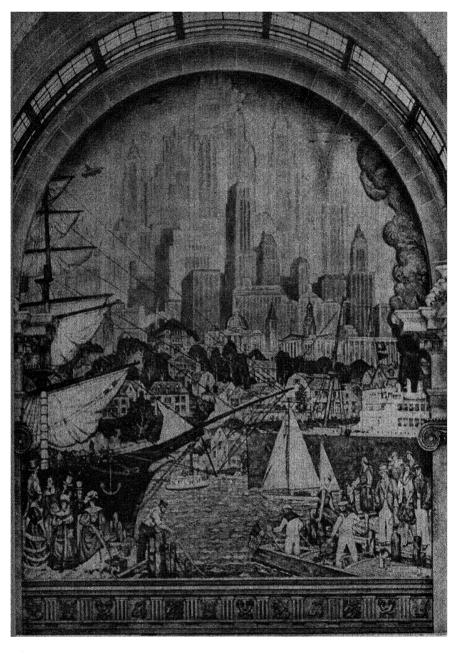
BANKING SYSTEMS OF THE UNITED STATES

Chapter XVII:

INTERNATIONAL EXCHANGE OF GOODS

Chapter XVIII:

**OBSTACLES TO TRADE** 



Courtesy of Brooklyn Savings Bank

BROOKLYN—YESTERDAY...TODAY...TOMORROW—There must be agencies to exchange the goods we produce. Above is pictured Brooklyn at two stages in its development, with an imagined third stage in the background. Note the means of exchange shown. If you would like to know what buildings and agencies are depicted, turn to page 494.

# Chapter IX

# The Mechanism of Exchange

### Aims of This Chapter:

To learn what exchange means.

To examine three systems of exchange.

To discover the factors needed for efficient exchange of goods.

To see why middlemen are essential in exchange.

To discuss attempts to eliminate middlemen.

In Part II you learned something about the process of creating the utilities that consumers desire. There you examined the factors that are necessary if production is to be carried on; you learned about the forms of industrial combination that have been organized to carry on the process. But it would not be sensible to produce goods in great quantities unless there were ways of disposing of them. Hence there must be exchange of the products of different producers. Under modern methods, goods are produced in anticipation of demands. If the goods are to be sold, there must be markets. Not only must there be markets, but there must be many other agencies to see that the exchange of goods is continuous. Among these agencies may be mentioned money, credit, banks, markets, middlemen, transportation and communication systems, foreign trade and exchange, and insurance against risks. When these agencies cooperate, commodities and services are exchanged smoothly and speedily. Part III will be devoted to a study of how goods are exchanged; this chapter will describe the mechanism of exchange as it exists today.

What Is Meant by Exchange?—Specialization is a prominent feature of our modern industry. Individuals specialize in some kind of work and produce standardized goods. In primitive society the individual produced the goods he needed and depended almost entirely upon himself. Today very few people make use of the goods they themselves produce. They hope to exchange them for the goods



Official U. S. Marine Corps Photo, Press Association, Inc.

BARTER IN THE SOUTH PACIFIC— Marine "blanket-and-freckles" (the Marine Corps term for roll-your-own cigarettes) buy almost anything in the South Pacific area. In this photo, native boys are bartering bananas for the American Marine's tobacco. made by others. When individuals are able to transfer or exchange goods that they do not want for goods that they do want, we have what is known as a "system of exchange." It may be defined as follows: Exchange is the process of transferring ownership of commodities and services.

There Are Three Systems of Exchange.—Ever since records have been kept, there has been some form of exchange among people. At first the process was very crude and unorganized. As time passed, improvements were made in the methods of exchanging goods and it is possible to recognize three distinct systems that have developed: barter, money, and credit systems.

Barter System or Direct Exchange. The first system of which there are evidences was the direct system of exchange of goods for goods. Under this system those who had a surplus of goods tried to find someone who wanted what they had to exchange and who had something that would fill their own needs. This was a very cum-

bersome method because it took a lot of time to find two persons who could agree on an exchange. Nevertheless, the system was used for many years and is still found in some sections. The method of exchanging one commodity directly for another commodity is called the barter system.

The barter system was crude and clumsy. It was not only difficult to find persons who could agree upon exchanges, but it was impossible at times to make exchanges because satisfactory terms could not be arranged. Many of the articles to be exchanged could not be divided into small units, thus making it almost impossible to carry on small transactions. An ox is worth much more than a bushel of corn or many bushels of corn, but it would not be convenient to divide the ox. Under these circumstances one party would have to take more of an article than he wished or not make the trade. Furthermore, there was no common measure of value and too many ratios of exchange had to be remembered. One ox had to be valued in terms of all the other articles that were exchangeable in the community.

Barter has taken on a new lease of life today. Not only is it still found in rural sections where farmers exchange eggs and butter for flour and cloth, but it is used also between nations. Before the Second World War, for example, Germany insisted upon an exchange of her goods for the goods she purchased from other nations. Brazil likewise entered into barter arrangements to dispose of her surplus coffee. Before we entered the Second World War, we exchanged several destroyers for British naval bases, a form of barter.

Money System.—Because of the inconvenience and wastefulness of the direct system of exchanging goods, traders sought for a better method. It was discovered that some commodities were wanted more than others by large numbers of people. These much-desired commodities were shells, furs, grains, and metals. It became possible to exchange goods for shells and to use the shells to obtain other goods. All communities did not confine themselves to the use of shells as the medium of exchange because each community had its own preferred medium. In time there came to be one commodity which was accepted generally by all communities in exchange and to this commodity was given the name money. When this came about there existed an indirect method of exchanging goods with some commonly accepted article as the go-between called the money system. This system had certain distinct advantages over the barter system and did away with many of the inconveniences of the older system.

Credit System.—The money system provided a much more satisfactory means of exchanging goods and increased greatly the business of trading commodities. But as population increased and communities grew up, there were more demands for goods; exchanges increased in number and size. Also it became evident that people did not always want to pay for the goods at the time they obtained them. They preferred to wait until they sold them in order to get the money with which to pay. Furthermore, it was not always safe or convenient to



Courtesy of Irwin Wasey & Company, Inc.

ADVERTISING—Without the service of advertising it would be impossible for consumers to find all the goods they want. In order to keep abreast of new developments, the advertising staff above analyzes the outstanding display achievements of the year.

carry large sums of money about. Thus people who had dealings with one another began to keep accounts and to sell goods without asking for payment at once. In this way the credit system was introduced. This is a system whereby something of value is obtained at one time for a promise to pay for it at another.

From what has been said above, it should not be inferred that each of these systems existed for a while and then gave way to a new one. As a matter of fact we have all three systems in existence today. The barter system is used to a limited extent; the money system is in common use for daily transactions of a relatively small nature; the credit system has outgrown the other two, for it is estimated that about 90 per cent of all the business done in the United States today is carried on by means of credit. In some transactions all three systems are used. For example, when you trade in your old automobile for a new one, by which the old car is swapped, this is barter; then a cash payment is required, which is a use of the money system; finally, you agree to pay a certain amount monthly until the car is paid for, which is a use of the credit system.

Many Agencies Are Needed for Efficient Exchange of Goods.—You have already learned that our system of exchanging commodities and services is complicated. Many factors enter into the process. When you consider that every day you are using articles that have

been made or produced in remote parts of the world, it will not surprise you to learn that many of these articles would not be available if a great many agencies had not cooperated to make them possible for you. There must be means of transportation, of communication, and of finance. There must be banks, a credit system, and markets, otherwise buyers would not know where to get the goods. If advertisers did not exist, you would not know that many useful articles existed. This means that all kinds of agencies must perform some service that we could not perform ourselves. Furthermore, there must be an honest system of weights and measures supervised and regulated by the government together with a system of laws to protect and control the system of exchange.

What Are Markets?—One of the essential factors in modern exchange is the market. It would be almost impossible to transfer the ownership of goods unless there were places where such transfers could be made. When you hear the term "market" used, you probably think of some definite place where buyers and sellers come together to carry on business. Although you are correct in thinking that these are markets, economists used the term in a much broader sense to include not only local but regional sections. It has been defined by one economist as any region in which buyers and sellers are so situated that they can engage freely in the purchase and sale of a given economic good. According to this definition there are many kinds of markets.

Kinds of Markets.—Markets may be classified in three different ways into various kinds: (1) wholesale and retail markets, which exist for almost every kind of commodity that is bought and sold; (2) commodity markets for the sale of all sorts of staple products, such as wool, cotton, leather, wheat, or sugar, in contrast to security markets for the sale of stocks, bonds, and commercial paper; and (3) local, national, and world markets.

Each of these three classifications of markets could be subdivided into many more. Thus there are wholesale and retail markets for securities and for staple commodities. You have heard of the wheat market, the cotton market, the egg market, the fruit market, the stock market, and many others. But the markets with which this book is chiefly concerned are the wholesale and retail markets dealing in the goods that consumers usually buy.

What Do Middlemen Do?—All the agencies that have been mentioned as necessary for the efficient conduct of exchange are



Wide World Photo

#### WHOLESALE

Brokers and commission merchants above are inspecting celery before purchasing it to resell to retailers. From retail stores throughout the country, the ordinary consumer makes his purchases.

#### AND RETAIL

Lambert from Frederic Lewis



called "middlemen." We may use the following definition: A middleman is an agent or agency which performs one or more of the necessary steps in the production of commodities between the primary producer and the final consumer. Many kinds of middlemen exist, and it would require too much space to describe them all. Among the better known are wholesalers, commission men, salesmen, bankers, transportation agencies, advertising agencies, and retailers. You will probably be able to add to the list:

Middlemen are considered essential in exchange because they perform so many useful services. If you stop to think of the many things you need and want, you will realize that very few, if any of them, could be obtained by your own efforts alone. You would not have the time and energy to obtain them even if you knew how. There must be someone who will take care of the numberless details necessary to get the various articles from the primary producer to you as the final consumer. The middleman attends to these details.

The middleman starts and finances his business, provides a place where goods can be processed, obtains the raw materials, hires the labor, installs machinery, provides a place to store the goods until they are wanted, sorts and grades articles, transports the goods from producers to consumers or to other producers, displays goods so that consumers may examine them, advertises them, sells them, and delivers them. These are all essential services without which exchange could hardly function today. Many other services are performed by middlemen; you can probably list several more services.

Are There Too Many Middlemen?—In spite of the fact that middlemen are very essential in the exchange process, there has been much criticism of them and their activities. Both farmers and consumers complain that middlemen add too much to the cost of goods. Manufacturers feel that profits would be increased if there were fewer agencies to demand a share of the profits. Consumers feel that they would pay less for goods if fewer middlemen existed. Because of these complaints, several efforts have been made to do away with certain middlemen. Only a few of these attempts will be described here.

Mail-order Houses.—You are familiar with the mail-order system through the large illustrated catalogues of mail-order firms. When the mail-order business began, many people had no means of getting to the shopping centers without great expense. This was especially true of those who lived in rural sections. They were glad to buy goods

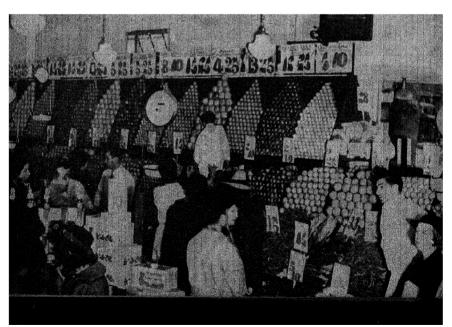
from an illustrated catalogue which gave a full description of the articles to be sold together with their prices and their costs of transportation. The mail-order houses claimed that they eliminated such middlemen as salesmen, commission men, and retailers.

Then came the automobile, which changed this situation. It is now possible to go to local stores and make purchases. This is more satisfactory, because buyers can examine the goods they wish to buy rather than depend upon a description in a catalogue. Moreover, catalogues cannot be kept up to date because prices change too rapidly. This is one reason why many mail-order houses have established chains of retail stores in various cities. Although all goods advertised in the catalogue cannot be bought directly in these stores, many can. With the establishment of retail stores, it is doubtful if mail-order houses have eliminated as many middlemen as is supposed. Without retail stores, mail-order houses themselves absorb many duties of middlemen.

Chain Stores.—The chain stores seek to eliminate such middlemen as jobbers, wholesalers, and commission men. The chains buy many of their goods directly from farmers and manufacturers; they sometimes maintain their own packing plants. But these chains have had to submit to heavy taxes; some states now tax them according to the number of stores in a chain.

A CHAIN STORE—This is called a supermarket. Note the variety of goods displayed. The customers serve themselves. What middlemen, if any, are eliminated?

Gates from Frederic Lewis



Direct Selling.—Many growers operate roadside stands near their farms rather than depend upon commission men to sell their produce for them. Some manufacturers use the mails and house-to-house canvassers. Such methods may bring good results, especially during a period of depression. But there is some doubt about the benefit consumers receive. It is also true that many producers still find it convenient to stock goods and to engage local salesmen and credit managers to handle their goods.

Department Stores.—You are familiar with these stores and have had dealings with them. They are as convenient as they are common. They combine under one roof many small stores called "departments." They claim to be able to eliminate such middlemen as jobbers, brokers, and some buyers. It is possible that by combining several departments under one management, some middlemen have been eliminated. Consumers have benefited by increased convenience and improved services, if not by lower prices.

Stores on Wheels.—In rural sections another method is being used to eliminate middlemen and to bring goods to consumers at lower prices. These are the so-called "markets on wheels," which are

A TRAVELING STORE—These enterprising young men have gathered a load of fruit and vegetables which they sell to consumers at the front doors of their homes. Do these customers obtain lower prices than they would at regular stores? What middlemen are eliminated?



actually motor trucks fitted up as stores with a fairly complete line of goods. Instead of a salesmen going around each week and taking small orders to be delivered later and instead of consumers being obliged to spend time finding places to park their cars in a congested city, the salesman drives his truck to the consumer's door and allows him to make a selection of goods on the spot. In this way much of the expense of hiring extra salesmen and employing delivery trucks is reduced. Goods can thus be sold at lower prices because marketing services are now performed by fewer middlemen.

Cooperative Organizations—These cooperative organizations aim to shorten the links in the chain from the primary producer to the final consumer and to pass the savings on to the members of the cooperative. We shall discuss them more fully in Chapter XXXIII.

Can Middlemen Be Eliminated?—Middlemen have been the target for much criticism; blame for high prices has been laid at their door. It has been pointed out that the criticism comes from both producers and consumers, but chiefly from consumers. Is there anything to be said for the middleman?

Many of those who object to middlemen are influenced greatly by the feeling that they pay too much for their goods. They do not take into consideration the important fact that production is not completed when the goods have been put into a useful form. Many other utilities must be created before the goods are available to consumers. In particular, time and place utilities must be added. For example, goods in a factory in Michigan are not of much use to a prospective consumer in Oregon or New York. Then, too, certain things are wanted quickly. How is it possible to obtain these goods when, as well as where, they are wanted? Naturally, someone must perform services, and someone must advance funds or the credit necessary to finance the goods from raw materials to finished products.

When all is said and done it seems to be evident that, although it may be possible to eliminate some middlemen, their functions still remain. These duties must be performed by someone else or be absorbed by the farmers or manufacturers who eliminate middlemen. There may be too many middlemen today, but it is not an easy matter to determine which of them should be eliminated. Perhaps it is true that middlemen are inclined to place too high a value on their services in order to justify their existence.

It might be possible to apply a test to determine whether a given

middleman is essential. If a middleman adds some utility to the article before it reaches the final consumer that would not be added otherwise, and if he adds this utility at a reasonable price, he might be considered essential and his services might be viewed as economical. This is merely a suggested test; other equally good ones might be applied. But it seems clear that in our complicated system of exchange consumers would not be able to obtain the goods they want when, where, and how they want them, unless there were middlemen of some sort.

Summary.—The process by which the ownership of commodities and services is transferred from one person to another is called exchange. It has existed from earliest times and has operated under three different systems. The earliest of these was the barter system, whereby goods were exchanged directly for other goods. This was followed by the money system, which is an indirect system of exchange carried on through the use of a medium acceptable to all in a community. Later the credit system was introduced; this is a system whereby goods are exchanged now for a promise to pay for them later.

If the exchange of goods is to be carried on with any degree of efficiency and speed, many agencies are needed. Among these are communication and transportation, money, credit, and markets. In addition, there are middlemen who perform services essential in modern business affairs.

The complaint has been made that there are too many of these middlemen, that some of them perform unnecessary functions, and that they add too much to the price consumers must pay for goods. Because of these complaints several attempts have been made to eliminate them. In a few cases some middlemen have been eliminated and consumers have gained by their reduction. But none of the attempts has succeeded in doing away with the services that must be performed. As long as the middleman renders an essential service at a reasonable cost, he will probably be retained.

### Questions to Test Your Knowledge

- 1. Give a definition of exchange.
- 2. Explain the barter system. Is it still in use?
- 3. What are the disadvantages of the barter system?
- 4. How does the money system differ from the barter system? from the credit system?

- 5. Name several agencies that are needed in the modern exchange process.
- 6. What is a market?
- 7. Name several kinds of markets.
- 8. How do you define middlemen?
- 9. List several functions performed by middlemen.
- 10. Why have producers and consumers objected to middlemen?
- 11. Discuss some of the efforts made to eliminate middlemen.
- 12. What middlemen are claimed to be eliminated by the following: chain stores? direct selling? department stores? mail-order houses?
- 13. What test might be applied to determine whether a middleman is useful or not?

### Questions for Discussion and Application

- 1. Discuss the need for some system of exchange today.
- 2. It has been said that middlemen may be eliminated but that their functions will still remain. Discuss this statement.
- 3. Would it be possible for all goods to be sold directly to consumers? Name some goods that cannot be sold in this way. What particular kinds of goods can best be sold directly to consumers?
- 4. Many supermarkets are being established today. They operate on a "cash and carry" basis with the customer selecting his own goods. Do you think that the consumer is actually benefited by this arrangement? What, if any, middlemen does this method of marketing eliminate?
- 5. Would you favor an extension of direct marketing to include other than articles of necessity or daily use? Give your reasons.
- 6. State your own views as to the place of middlemen in industry.
- 7. Discuss the place of chain stores in our society. Why have they been subjected to heavy taxation?

### Floor Talks and Written Reports

- 1. A community without middlemen.
- 2. International barter.
- 3. Markets in our economic system.

### Topic for Debate

RESOLVED, That the inhabitants of each community should purchase all their goods from local merchants.

### For Further Information

Cole, J. V., "The Consumer-buyer and the Market."

Fairchild, F. R., E. S. Furniss, and N. S. Buck, "Elementary Economics," Vol. I, Chap. VIII.

Leblar, G. M., "The Chain Store, Bain or Boon"?

Public Affairs Pamphlets, "Chain Stores, Pro and Con," No. 40.

Reid, M. G., "Consumers and the Market."

#### PROBLEM 12

### Why the Middleman?

This question is one that has been asked many times and as often has failed to receive a satisfactory answer. There are those who see no reason for the middleman and would do away with him entirely. They would bring the producer in as close contact with the consumer as is humanly possible. Their slogan is "From producer to consumer direct." These people forget that their slogan does not represent progress at all but rather a step backward to the age of barter.

In the olden days when our life was simple and industry had not yet developed machines and mass production, the barter system was the only one known and used. The farmer of those days exchanged his produce and his labor directly for the things that satisfied his wants. Others did the same. No other system was known and everyone seemed satisfied.

But times have changed. There are more people wanting commodities and services. These commodities and services have multiplied in number and kind. Life has become more complex. The barter system no longer suffices. An individual can no longer satisfy his needs by his own efforts. He has to depend on others if he is to satisfy his numerous wants and exchange his products and services. Those who help him to exchange his products and services for the things he wants are known as middlemen.

Middlemen came into existence as the result of the working of economic law. They were needed and they came to supply the need. No matter by what name they may be called, if they assist the producer to market his goods and the consumer to obtain what he wants, they are middlemen. If those who wish to eliminate middlemen are to succeed, they will have to find a way for the producer himself to perform the functions now performed by the middleman. Our economic life is so complicated and we have accustomed ourselves to such a variety of articles, that it does not seem likely that we can dispense with those who make it possible for us to satisfy our present wants.

- 1. Name some important functions performed by middlemen.
- 2. Why do producers not try to sell their goods direct to consumers?

- 3. How much of a breakfast would you have had this morning if you had been obliged to procure the articles directly from the producers?
- 4. What, if any, middlemen would you eliminate? Why?
- 5. How would you distinguish between middlemen who are useful and those who are not useful?

(Adapted from "Everyday Economics" by R. M. Rutledge, pp. 3-5, by permission of the publishers, Houghton Mifflin Company, Boston.)

#### PROBLEM 13

#### Mail-order Houses vs. Local Merchants

In a certain fairly prosperous agricultural community in New England, the local merchants found that they were losing business because many of their customers were purchasing more and more of their needs through the mail-order houses. At a meeting of the merchants to see what could be done about this state of affairs, many arguments were brought forward, chief among which was that the people of the community would profit more by spending their money at home.

- 1. Just how far is this argument valid?
- 2. Do mail-order houses undersell local merchants?
- 3. To what extent is advertising a factor in the success of the mail-order house?
- 4. Can local merchants use to advantage the methods used by the mail-order houses? Why or why not?
- 5. How may local newspapers be used to advantage by local merchants in their competition with mail-order houses?
- 6. What suggestions would you give the local merchants to help them meet their problem?

# Chapter X

# Some Principles of Exchange

### Aims of This Chapter:

To learn the meaning of value.

To see how value and price are related.

To examine the laws of demand.

To discover the distinction between elastic and inelastic demand.

To find out how market price is determined.

The preceding chapter explained what exchange means and discussed the agencies needed to make exchange function smoothly. This chapter will explain some of the important principles underlying the process of exchange.

What Does Value Mean?—Value is a term that you have used many times without giving much thought to just what you had in mind when you used it. It is not necessary to enter upon a technical discussion of value; but you should have a clear idea of the distinction between value used as utility and value used in exchange. In general it may be said that value means the worth of a thing to its possessor.

If you own a watch that was given you by someone whom you greatly admired, you place a certain value upon it. But this watch may not have much value to anyone else. Again, a prize that you won has more value to you than it has to anyone else. This is a personal way of looking at value and is known as *value in use*. It is of little interest to us in this discussion of value.

Our interest is in what we can get for an article if we try to exchange it for something else. Farmers, manufacturers, and owners of mines do not want for themselves all of the products that they produce. They want to exchange them for other articles. The same is true of those who render services. The doctor wants to exchange his skill for goods that will satisfy his wants. When a bushel of wheat is said

to be twice as valuable as a bushel of corn or when we say a doctor's call is worth one cord of wood, we are referring to the exchange ratio between them. This is called *value in exchange* and may be defined as the power of a good to command other goods in exchange. This is the sense in which the term will be used in this book.

What Does Price Mean?—No one any longer expresses the worth of a thing in terms of other things. As we learned in an earlier chapter, people sought to exchange goods through a common denominator which was called "money." Today we compare ratios of exchange in terms of money. The exchange value of anything expressed in terms of money is called price. In the United States prices are expressed in dollars and cents. A pair of shoes priced at \$6 is considered as being worth three times as much as a shirt at \$2. The \$6 measures the value of the pair of shoes in our money unit.

We have defined price as it is used in a general sense. But there is another kind of price with which you should become familiar. This is what is known as "market price." Market price is the price at which a good is exchanged in the market from day to day. Market price is not a fixed price by any means because in the case of some goods it varies from day to day and for others it may vary from hour to hour. If you look at the quotations of the New York Stock Exchange for a busy day, you will find that the prices of many stocks are changing rapidly. Just how market price is determined will be explained later in this chapter after we have explained a few more terms used in exchange.

How Are Desires Turned into Demands?—The distinction between the terms "desires" and "demands" is important in economics. Some might say that the terms mean the same thing, but they do not. A desire is only a wish or a want for something, and you have experienced plenty of wants. But as long as you only express a wish for a thing, you will never create a demand for it. There must be something more than a wish or desire to cause you to purchase the article in question. No sensible businessman would be likely to stock his store with goods merely because he knows people have desires. If he did not feel quite certain that people had the means with which to buy his goods, he would not have them on hand. By advertising his goods and by setting a reasonable price for them, he induces people to change their desires into demands.

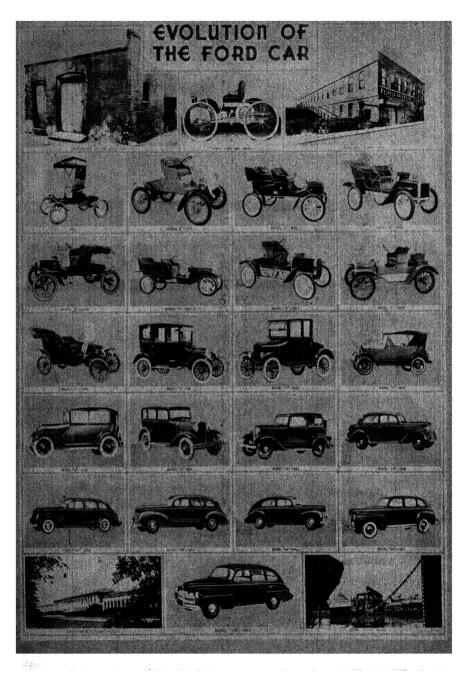
How is a demand created? An example will serve to show you. Suppose you desire a certain style of hat which is being worn by your

companions. On your way home you gaze longingly at the store window where the hat is displayed. If you look at the hat and pass on, you have not created a demand for the hat. But if you enter the store, examine the hat, express a desire for it, and pay the price asked, you have created a demand. Of course, the hat was there all the time you were wanting it and you may wonder why hats are made before anyone demands them. The answer is that under our system of mass production goods are manufactured in anticipation of demand because the manufacturers have learned from experience that by means of advertising, salesmanship, and credit plans they can induce people to turn their wants into demands. We are now ready to define demand. Demand is the desire for a commodity plus the ability and willingness to pay for it.

How Is Demand Influenced?—Why is it that people sometimes demand more of some things than of others; demand some things at one time and then cease to demand these things? You know that demands vary and perhaps have wondered why. There are many things that influence our demands, and these need to be examined carefully as they are important.

Influence of Price.—Price is a very important factor in determining demands. When prices are high people have a tendency to buy fewer things; when prices are low they tend to buy more things. More of certain things will be bought if the price is low; and less will be taken if the price is high. In other words, if prices go up, the quantity of goods sold tends to decrease; if prices go down, the quantity of goods sold tends to increase. This leads to the statement of one of the laws of demand: Other things being equal, demand varies inversely with the price.

Influence of Purchasing Power.—By purchasing power is generally meant the amount of money people have for the purchase of goods. The purchasing power of an individual or of a community has a very decided effect on demand. The more money people have to spend, the more goods they tend to buy; the less money they have, the fewer goods they tend to buy. But this is not the whole story. It is not only the amount of money that counts. There are many other factors that enter into purchasing power, one of which is the amount of goods one can buy with the money available. Thus it may be said that purchasing power in general means the number of dollars that can be spent together with the amount of goods that can be bought with these dollars at the time.



Courtesy of Ford News Bureau

LOW PRICE INCREASES DEMAND—Henry Ford's low-priced car was within the price range of the average citizen. The demand for these cheaper cars skyrocketed, and, with the maintenance of a low-price policy, it has remained at a peak throughout the years.







Frank Cause

LESS FOR HIS MONEY—Purchasing power has a very decided effect on demand. When the price of a lollipop is ½ cent, the boy who has only 1 cent to spend can buy enough to satisfy himself and his girl. But when the price increases, he is able to purchase only enough to satisfy one person—the girl. Result: someone is dissatisfied.

A few examples will help you see how purchasing power affects demands. If the income of a family is increased while the prices of the goods the family ordinarily buys remain the same, the purchasing power of the family has been increased. This being the case, it is probable that the family will buy more goods. But if the family income should be reduced while prices remain the same as they were, the purchasing power of the family has been reduced. In this case the family will probably purchase fewer goods. Of course, it is possible that instead of buying fewer of the goods they ordinarily use, the family may now purchase cheaper goods, or substitutes, and thus have the same purchasing power. In general we may say that, other things being equal, demand varies directly with the purchasing power.

Influence of Utility of Goods.—Not only are demands influenced by prices and purchasing power, but they are greatly influenced by the utility of the goods themselves. If a commodity is of little use to you, you usually do not buy it. But if the commodity is very useful to you, you purchase it if you are able to. Each individual is the judge of the utility of an article or a service to him. Some people buy things that other people would never buy. This means that people value things differently. Nevertheless, the general rule holds good in most cases that, other things being equal, demand varies directly with the utility of the good.

We have explained the three outstanding factors that influence our demands. But there are many other factors that enter in to cause us to demand things or to cease to demand these things. We have space to mention only a few of these factors. Many personal factors influence demands, such as age, sex, habits, social position, training, and wealth. Then there are such things as changes in style and tastes, new products, new inventions, new processes of manufacturing goods, advertisements, salesmanship, and such emotions as fear, jealousy, and imitation.

From what has been said you can see that this problem of demand is not a simple one and that many things have to be considered before you can be sure it is understood. But from the fundamental principles that have been explained, you will gain an understanding of the nature of demand.

An explanation of one other characteristic of demand will help to make matters a little clearer. We refer to the fact that some goods are subject to changes in demand through a change in price and others are not.

How Does Elastic Demand Differ from Inelastic Demand?—If you were to talk with your parents, they would probably tell you that there were many articles they would buy if prices were different and that they would not buy more of certain articles even though the prices were to drop. This means that the demand for some goods increases when the price drops, even though the drop in price may be slight; and that the demand for these same goods would disappear if the prices were raised much. In economics we say that the demand for such goods is elastic. When a change in price, even though slight, causes considerably more or less of certain goods to be bought, the demand for these goods is said to be elastic.

On the other hand, there are certain articles in common use that are bought regardless of price or, rather, that are bought in almost the same amount even though there may be a substantial change in price. If the price of matches, salt, or bread were raised, we should probably not buy much less of these articles. Likewise, if the price were to drop sharply, we should probably not buy much more of them. When a change in price causes very little change in the quantity bought, there is said to be an inelastic demand for the article.

Many articles of luxury and most comforts are subject to elastic demand. When a reduction in the price of automobiles, radios, or refrigerators is announced, the number of these articles bought increases. If the price of these same articles should be raised, there would be a decline in the number bought. Most articles of necessity or those things we use regularly in our daily living are subject to



Wide World Photos

SALE—The Boston shop pictured above is crammed with clamoring women, attracted by low prices as well as by the rapidly diminishing supply of silk hose which was available in the prewar days of 1941. Luxuries like silk stockings are subject to elastic demand, which is affected by price changes.

inelastic demand. We have become accustomed to buying a certain amount of these things, and changes in price do not cause us to demand more or less.

This matter of elastic and inelastic demand can be made clearer if we use schedules and graphs. In the accompanying table there is a demand schedule for automobiles to which has been added the total receipts that will be realized from the sale of automobiles at the various prices and quantities given in the schedule. This table shows that people will, at a given time, spend more for automobiles at lower prices than at higher prices.

AN ELASTIC DEMAND SCHEDULE FOR AUTOMOBILES

Price per car	Quantity that will be sold	Total receipts
\$1,700	100,000	\$170,000,000
1,500	200,000	300,000,000
1,300	400,000	520,000,000
1,000	700,000	700,000,000
800	1,000,000	800,000,000
500	1,800,000	900,000,000



Graphic representation of elastic demand based on the table on page 151.

The following table shows the demand schedule for bread. This table shows that, as the price of bread is reduced, the total amount spent by people for bread declines instead of increasing, as is the case with automobiles. Again, the number of units sold increases slightly rather than greatly with a reduction in price.

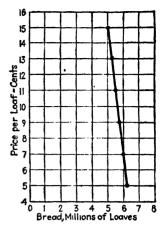
INELASTIC DEMAND SCHEDULE FOR BREAD

Price per loaf in cents	Quantity that will be sold	Total receipts
15	5,000,000	\$750,000
13	5,300,000	689,000
11	5,500,000	605,000
9	5,750,000	517,500
7	6,000,000	420,000
5	6,200,000	310,000

How Do Prices Affect Supply of Goods?—You have learned several things about demand; but little has been said about supply. Of course, there would be no use in demanding goods if there were no goods to be had. In order that demands may be satisfied, there must be a supply of goods. Those who have articles to sell will not sell them unless they can get a good price for them. As the price offered for the article rises, more of these goods will be offered for sale; as the price offered drops, less of these goods will be offered for sale. This leads to the general law of supply, which is stated as follows: The quantity of goods that will be supplied varies directly with the price.

#### How Is Market Price Determined?-

Market price has been defined as that price at which a good is exchanged in the market from day to day. How is this market price determined? In every market there are two groups: the buyers and the sellers. Buyers are desirous of obtaining goods as cheaply as possible, while sellers wish to get as high a price for their goods as possible. The buyers and sellers are also made up of different groups. Some buyers are willing and able to pay more than others to obtain what they want; likewise, some sellers are able and willing to sell their goods at a lower price than others. Thus there is competition among sellers and among buyers.



Graphic representation of inelastic demand based on the table on page 152.

Let us illustrate this by the accompanying table.

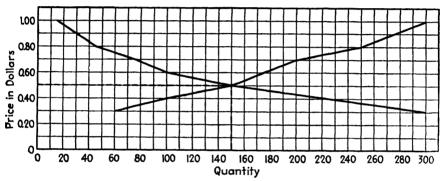
DETERMINATION OF MARKET PRICE

What buyers will demand	Price	What sellers will supply
15	\$1.00	300
30	0.90	275
45	0.80	250
75	0 70	200
100	0 60	175
150	0 50	150
225	0.40	100
300	0 30	60

If you will recall the laws of demand and supply that you have learned, you will note that, as the price declines, the effective demand tends to increase; and as the price rises, more will be offered. Examining the table, you will see that at a price of \$1 only fifteen units of this product will be demanded but that 300 units will be offered for sale. At this price many sellers will be unable to dispose of their product and, since they cannot afford to sell for less than \$1, they withdraw their product from the market. Some sellers can afford to sell at a price of 90 cents and offer 275 units at this price. The reduction in price has caused the demand to rise but only for thirty units. As the price is reduced the quantity that will be taken by buyers increases, while the quantity supplied by sellers drops. This process of reducing

the price goes on until a price is reached at which the same number of units is offered and taken. According to the table, this price is 50 cents. There is agreement among buyers and sellers at this price, and under the conditions of the table this will be the market price.

This situation can be further illustrated by means of a graph. It is customary to indicate prices on the vertical line beginning at the bottom with the lowest price. Quantities are usually arranged along the horizontal line with the smallest quantity at the left. Note that *all* quantities are arranged on the horizontal line. Since effective demand drops as the price rises, the demand curve will be a downward curve. And since supply increases as the price rises, the supply curve will be



MARKET PRICE—Above is shown a graphic representation of the determination of market price.

upward. These two curves are bound to cross somewhere. Where they cross will be the market price. If you study the accompanying graph, you will be able to make graphs of your own when the need arises.

Why Do Market Prices Vary?—A few words of explanation are in order. When demand and supply are equal, the market takes care of the greatest number of buyers and sellers. Thus it may be said that the market price balances supply and demand. Of course, our table represents an ideal case, for situations such as pictured there seldom occur. It is quite likely that the actual market price would be somewhere between 40 and 50 cents under normal conditions. But this need not disturb you because the example will serve to show you how the market price is determined.

There are many reasons why market prices vary, but we shall confine our discussion to only five of them.

Taxes.—Nearly every product of any importance is now subject to a tax of some kind, direct or indirect. When a tax is placed upon an article, the producer or the dealer passes it on to the consumer. This usually means a rise in the price. Examples are taxes placed upon cosmetics, playing cards, cigarettes, and gasoline.

Fixed Charges.—These are charges such as taxes, interest, or rent, which must be met whether business is good or bad. Many businesses operate under high fixed charges. In order to meet these charges, at least in part, it may be necessary for a dealer to lower his prices to or below his total costs of production, in order to induce people to buy. This reduction in price may be only temporary.

Fashions and Fads.—When a new style is first brought out, people are very keen to buy it and the producer places a higher price on it. But as soon as the people have tired of this style or it is displaced by a later style, the dealer is compelled to lower the price if he wishes to sell it.

Customary Prices.—A customary price is one that has been in effect so long that people look upon it as the proper price and dislike to pay a higher price. This makes it difficult for dealers to change the price.

Monopoly Price.—A monopoly has sufficient control over the supply or demand or both to regulate the price of its product. Monopoly price is fixed at that price which will give the greatest net profit to the monopoly. Although costs of production put a "floor" under monopoly price, competition does not put a "ceiling" over it. A competitive price, on the contrary and in spite of day to day changes in market price, tends to raise costs of production.

The five factors named above affect market prices when conditions are normal. But when a nation wages a total war and precedence must be given to the production of those materials essential to winning the war, market prices are upset. As soon as normal times return, these factors again begin to operate to affect market prices.

Summary.—Value and price are two very important terms. Value is the power of a good to command other goods in exchange. When this exchange value is expressed in terms of money, it is called price. In ordinary usage we think of market price when price is mentioned. Market price is the price at which goods are exchanged from day to day.



Hirz from Frederic Lewis

FASHION CHANGES—Changes in fashions affect market prices. Changes in style are particularly striking if we look through an album of our grandmother's day. The photo above is of a bridal couple of about seventy-five years ago.

Another term of much importance is demand, which is defined as the desire for a commodity accompanied by the ability and willingness to pay for it. Demand is essential if there is to be any exchange of commodities and services.

Demand is influenced by several factors. Chief among these is price, because any change in price tends to cause a change in the quantity of goods demanded. That is, if the price rises, the effective demand declines; if the price falls, the effective demand rises. Purchasing power is another factor influencing demands. As purchasing power rises, demands tend to increase and vice versa. The utility of the article makes a difference in the demand for it. The more useful an article is the more likely you are to demand it and vice versa. Other factors affecting demand are age, sex, social position, habits and customs, changes in style and tastes, new products and inventions, advertisements, and the desire to imitate others.

There are some instances in which a change in price makes little difference in demand. In the case of things we need to buy anyway, changes in price do not cause any noticeable change in demand; but in the case of many luxuries and most comforts, a slight change in price may cause more or less to be bought. Necessities are subject to inelastic demand, while many luxuries and most comforts are subject to elastic demand.

Market price is not a fixed price but varies from day to day. It is determined by a process of bargaining between buyers and sellers

until a price is arrived at that satisfies the greatest number of buyers and sellers. This process is complicated by such influences as taxes, fixed charges, fashions, fads, customary prices, and monopoly prices. Long-run competitive price tends toward costs of production. Monopoly price is fixed at the level of greatest net profit to the monopoly.

## Questions to Test Your Knowledge

- 1. Define value.
- 2. What is meant by value in exchange?
- 3. Define price.
- 4. What is meant by market price?
- 5. Distinguish between desire and demand. Give examples of each.
- 6. How does price influence demand?
- 7. Show that demand is influenced by purchasing power.
- 8. How does the utility of goods affect the demand for the goods?
- 9. Name several other factors that affect demand.
- 10. Distinguish between elastic and inelastic demand for goods.
- 11. How is market price determined?
- 12. What are some factors that cause market prices to vary?

### Questions for Discussion and Application

- 1. It is said that advertising exerts a strong influence upon demands. Does advertising create new demands, or does it cause a demand for one thing rather than another?
- 2. Show how the purchasing power of a family affects its standard of living.
- 3. Discuss the relationship between a family's social standing in the community and the type of demands it has.
- 4. From newspapers and magazines clip several advertisements in which goods are offered at reduced prices. Is the demand for any of these goods elastic? inelastic? Classify the goods advertised as necessities and luxuries.
- 5. Discuss the effect that taxes and fixed charges have upon the fixing of a price at which goods may be sold.
- 6. There is a very close relationship among demand, supply, and price. If the demand for a certain commodity increases, what is likely to be the effect on the supply of that commodity? on the price of that commodity? State the law that shows the relationship among demand, supply, and price.

### Floor Talks and Written Reports

- 1. Influence of consumers in fixing prices.
- 2. Consumers' strikes.
- 3. Why market prices vary.

### Topic for Debate

RESOLVED, 'That unrestricted competition creates prices fair to both buyers and sellers

## For Further Information

Cnase, S., and F. J. Schlink, "Your Money's Worth."

Fairchild, F. R., E. S. Furniss, and N. S. Buck, "Elementary Economics," Vol. I Chaps. XI-XVI!I.

Gemmill, P. F., "Fundamentals of Economics," Chaps. 15, 17.

Public Affairs Pamphlets, "How Money Works," No. 45; "More for Your Money," No. 63.

#### PROBLEM 14

#### What Will Be the Market Price?

Using the following demand and supply schedule, what will be the market price for peaches? How many bushels will be sold at this price? Following the instructions on page 154, make a graph to show how you arrived at the market price. Be prepared to explain each step in the problem.

Number of bushels	Price	Number of bushels
offered	THE	bought
250,000	\$1.60	50,000
200,000	1 40	80,000
175,000	1 25	90,000
150,000	1.00	100,000
120,000	0 90	120,000
100,000	0 80	150,000
50,000	0 70	200,000

Discuss reasons why conditions might lead some of the sellers to sacrifice their peaches at a much lower price than the market price even though it might mean some loss.

#### PROBLEM 15

### Do You Get Value When You Buy?

Consumers, as a rule, know that they get a better price for the things they buy in quantities than for the things they buy in small units. There are exceptions to this rule, of course. But in the main it holds true. In the case of some standard articles, usually purchased in drugstores, an investigation showed that in more than half the cases the consumer received more for his money when he purchased the 10-cent size than when he bought the so-called "regular" size. This was found to be true in other studies made of cosmetics and toilet articles.

The consumer is wise if he reads carefully the labels on all the products he buys. Whenever the quantity is stated, it should be compared with the price for each size offered. If you wish to determine how much each size gives you for your money, divide the price in cents by the quantity. For example, take two jars of cold cream. One contains two ounces and sells for 10 cents; the other contains four ounces and sells for 25 cents. The smaller size is the better buy, because the price would be 5 cents per ounce, while the larger size gives you a price of 6.3 cents per ounce.

Many consumers are under the impression that price is a measure of quality. However, this is not always true. If you pay a higher price for an article, it does not necessarily follow that you get a better quality than if you pay less. Foodstuffs are frequently sold at first-grade prices when they are actually third grade in quality. This has been proved by the Food and Drug Administration.

The consumer should not be misled into believing that the cheapest articles are always the best buy. Nearly every buyer has found at times that lower priced articles are often as good as the more expensive ones, or even better. However, consumers often obtain poor bargains when they buy articles merely because they are cheap. If the consumer buys the cheapest article of an honest manufacturer, he often finds that it is of lower quality than the high-priced articles made by this same concern. Again, if a consumer tries to buy something that sells for considerably less than the general price asked for that type of product, he is likely to get cheated. Whenever one buys at a greatly reduced price, he should try to determine whether the quality of the lower priced article really is comparable to the quality of the higher priced goods. In the case of some articles labels will often help to do this.

When a consumer buys products for which standards exist, he should use standards rather than price as a guide to quality. However, he should first be sure of the reliability of the agency that sets the standard and know the meaning of the particular standard. By following these general observations, the consumer will get better value for the money he spends.

- 1. Distinguish between value and price.
- 2. What is meant by standard articles?
- 3. Why is it important to read all labels carefully?
- 4. Show that price is not always a measure of quality.
- 5. Do you follow any of these rules when buying? Why, or why not?

# Chapter XI

# Money and What It Does

### Aims of This Chapter:

To define money.

To learn the qualities of good money.

To find out what services money performs.

To learn how to detect counterfeit money.

To see how money is made and put into circulation.

Now that you have learned about the system of exchange, the factors needed for efficient exchange of goods, and a few of the important principles of exchange, you will want to learn about another very essential factor, namely, money. This chapter will explain what money is and what it does.

What Is Money?—A story is told about a well-known economist who once gave a lecture on money. He tried to make his remarks simple and clear. To find out how well his lecture had been understood, he asked a small boy who had been listening attentively what he thought money was. Quick as a flash the boy replied, "Money is what the other fellow takes for what you want." This reply may not have been as scientific as the economist would have liked, but it was not a bad reply after all. The boy defined money in a way that makes it clear to everyone because it is what the person with whom you are dealing will accept in exchange for what he has to offer you.

Let us illustrate this by an example. If you had been living in colonial days and wished to trade with another boy or girl, you would have used shells, beads, or skins, since these were the things that would have been acceptable at that time. But if you wish to trade today, you would not use these things at all because you now have something that is much more convenient, called "money." It is convenient because it circulates freely from hand to hand as a means of paying for commodities and services. This means that it is generally accept-

able without any doubt as to its value. Now we shall give a more scientific definition of money. Money is anything that is generally acceptable in a community in exchange for all other commodities and services.

Why Do We Need Money?—Before money came into use, there was only one way by which a person could obtain the commodities he wished. This was by exchanging one article directly for another article. This was called "barter." You have learned about the disadvantages of this method of exchanging goods, and so you can understand that those who wished to trade were desirous of finding a more convenient method. A more satisfactory medium must be found, and thus the need for what is now called money arose. We need money because some common denominator of value is necessary in our complicated exchange system.

What Articles Have Been Used as Money?—The metal coins and paper bills with which you are familiar today did not come into existence at once. The search for something that everyone in a community would accept and that had value in itself was a long one. At first such things as cattle, grains, and skins were in common use. These were used because they were things that were generally useful in other ways and so were accepted in exchange for commodities and services. Almost any article that was desired as an ornament was used at one time for purposes of exchange. These included such things as beads, jewels, earrings, and other ornaments. Then came the use of certain metals, such as iron, silver, and gold. One of our colonies had the distinction of growing its own money, tobacco. This was money because it was useful in trade; it possessed general acceptability throughout the community.

Many more articles could be named which served as money at one time and in some places. But, although they were generally acceptable throughout the community, they lacked certain qualities good money should have. Some of them were perishable, some lost value in a short time, some were too bulky to carry around, and many could not be divided conveniently so that small transactions might be carried on. So the search continued for a money commodity that would not have these defects and deficiencies.

What Are the Desirable Qualities of Good Money?—Several qualities are deemed necessary if the commodity is to serve satisfactorily as money. These will be described briefly.

It Should Be Something That Everybody Will Accept.—Unless the article is something that people want for its own sake because it has value in itself, it will not make a good money commodity.

It Should Be Durable.—The objection made to many of the articles once used as a medium of exchange was that they did not last long enough. Thus cattle were unsatisfactory because so many things could happen to them to destroy their usefulness as money. Tobacco deteriorated, grains perished, and shells cracked and broke. An article that goes to pieces while it is being used in exchange cannot be called a very satisfactory medium of exchange. To be a good money medium an article must be able to withstand reasonable wear and tear for a long period of time.

It Should Be Stable in Value.—Too many of the early forms of money were not stable in value. Tobacco, grains, skins, and cattle changed in value from time to time and sometimes lost value altogether.

It Should Be Something That Can Be Divided into Small Units without Destroying Its Value.—It would have been disastrous to try to divide an ox in order to exchange part of it for an article of small value. Likewise, a skin would be ruined if it were cut up into small bits to purchase a spear or a fishhook. Many of our daily transactions involve trifling amounts of money. Any commodity that is to serve us well must be something that can be divided into parts and yet not become valueless. A good money commodity today must serve to purchase a newspaper or a suit of clothes.

It Should Be Easy to Carry About in Reasonable Quantities.—No one would claim that it is easy to carry about a bushel or more of corn or several pounds of tobacco. It would be rather bothersome to carry with you enough iron or skins to pay for a canoe or a radio set. Thus, to be a good money medium the article should be something that has large value in small bulk. This makes it easier to carry large sums when necessary.

It Should Be Recognized Easily.—A good money medium should be something that is easily recognized by everyone because of its form, weight, or color. Unless it can be distinguished easily from cheaper substitutes, it will be too easy to counterfeit. Although some of the early forms of money had this quality, too many others lacked it. People were cheated because of this fact. No one now has any difficulty in recognizing a quarter, a silver dollar, or a paper note.

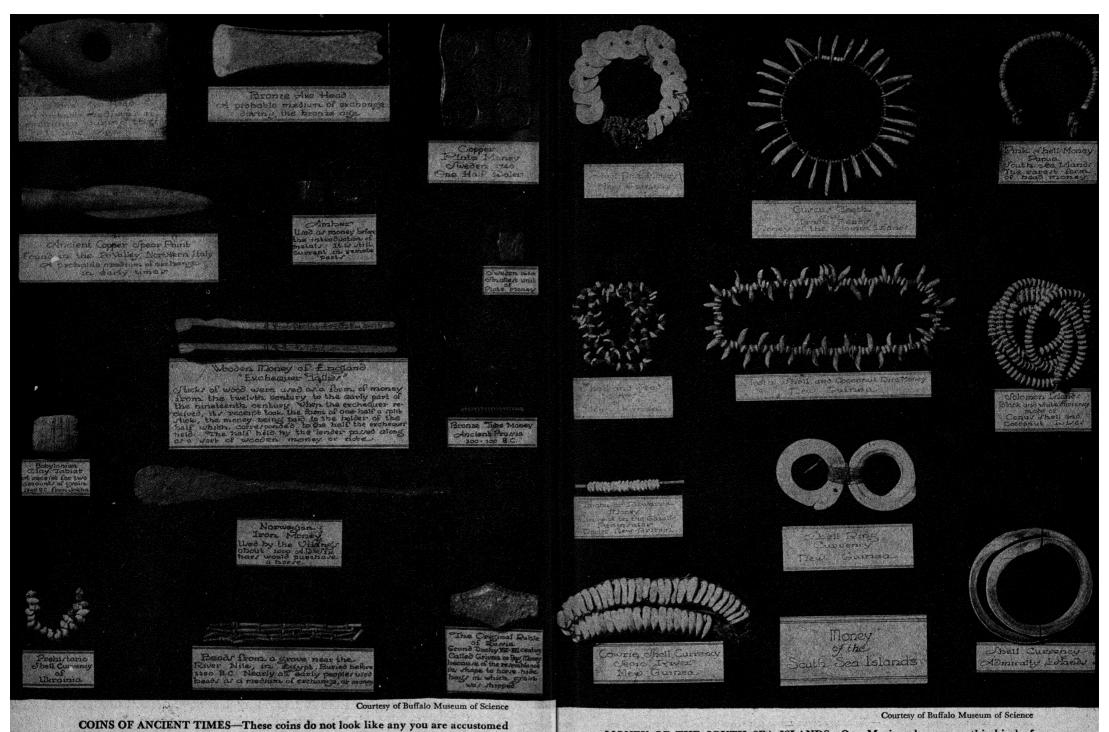
It Should Be Uniform in Quality.—Early forms of money, such as tobacco, grains, shells, and skins, were not uniform in quality. Some were of good grade but others were inferior. If a commodity is to serve as good money it should have uniformity. All our coins are made according to a definite formula and are standard in quality. An ounce of gold is exactly like every other ounce of gold; it is the same in all parts of the world. Thus gold possesses almost perfect uniformity in quality.

If you examine the seven qualities described above, you will observe that no article used as money has all of them in a complete sense. In other words, there is no perfect money commodity. But gold and silver, more than any other metals, possess these qualities and so have been more commonly used as money than any others. Gold has value in itself and so is very acceptable; it wears well and its durability is increased by adding another metal to it; it is easily recognized; and it is uniform in quality. However, gold is too valuable to be divisible in small units for practical purposes in everyday use. Silver ranks next to gold in the possession of these desirable qualities. It is especially useful for coins of intermediate value. Thus gold and silver have displaced other commodities in the money systems of the world.

What Services Does Money Perform?—The use of money came about because it serves so many useful purposes. We shall describe the four outstanding services performed by money.

It Serves as a Medium of Exchange.—This service has already been mentioned several times and does not need much more explanation. Money serves as the medium through which all business transactions are carried on. Your father may work in an office or a factory, while the father of your chum may conduct a retail clothing business. Your father receives his wages in the form of money. Part of this he gives to the storekeeper for a hat or a shirt. The storekeeper, in turn, uses this money to pay a manufacturer in another city for the goods he has bought to sell. Money has made these exchanges possible.

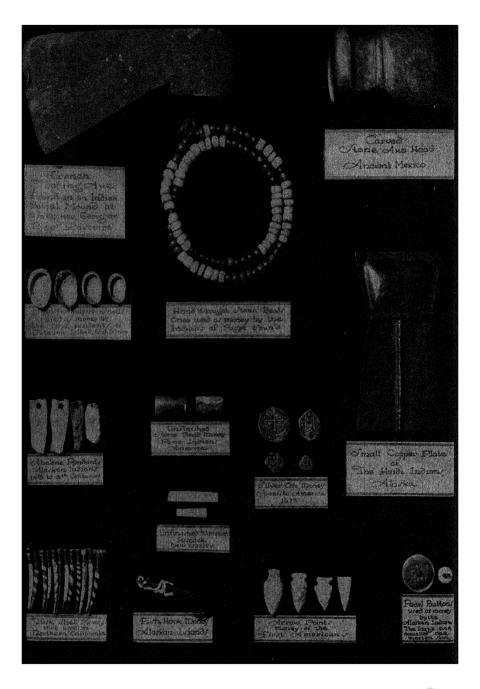
It Measures Value.—Under the barter system it was difficult to make a satisfactory exchange of goods because there was no reliable way of measuring the value of the goods exchanged. But when money came into use, it was possible to make any exchange desired and to have the parties satisfied. Money serves as the measuring rod of value. Money makes it possible for us to quote prices for all commodities and services. In fact, if we could not talk in terms of money, we should



to seeing. Why were they used as coins? What qualifications of good money do they

lack?

MONEY OF THE SOUTH SEA ISLANDS—Our Marines have seen this kind of money in use, but probably you never have. Why would these pieces of money not be useful to us today?



Courtesy of Buffalo Museum of Science

EARLY AMERICAN MONEY—Here are some more peculiar pieces of money, which were once good coins in our own country. How many can you identify? What qualities do they lack?

find it difficult to say how much anything is worth. When anyone says he earns \$20 a week, is worth \$10,000, or is paid \$5 for a pair of shoes, he is using money to measure value in each case.

It Serves as a Standard for Postponed Payments.—All goods are not paid for as soon as they are delivered. It is quite usual to work for someone for a week or a month before receiving wages, or to buy a watch and pay for it some time later. There must be some way to measure the value of these future payments. Money performs this service quite well for short periods of time. Thus money serves as a standard for postponed payments as well as the measure of value in the present.

It Serves as a Storehouse of Value.—Money contains within itself value in a convenient form for carrying about from place to place. This makes it possible for people who wish to do so to put money away in a strongbox or to protect it from thieves. This is called "hoarding." Value is stored away for future use. When you put money in a savings bank, you are storing its value for future use. But this is not hoarding because the money is available when needed and is usually put to work by the bank. When a bank sets aside a sum of money to maintain a reserve against deposits, it is also making use of this function of money.

How Is Money Coined?—When the government manufactures metal coins of certified weight and purity, it is called coinage. The metal used to make coins must first be purified and then some other metal added to harden it. The metal added for this purpose is called an alloy. The combination of pure metal and alloy in the proper proportions is called bullion. This bullion is made into bars which contain about 90 per cent of pure metal and 10 per cent of alloy. The bullion bars are rolled and flattened into strips the thickness of the desired coin and then run through a machine which stamps the design and description on both sides.

Coinage is an old process, having been used for centuries. According to the records the first coins were not all one shape, some being square, some rectangular, and some round. They were also made according to a certain weight which was stamped upon them. In some countries we still find coins known by a name that designates a weight. In England there is the pound sterling, in France the livre, and in Greece the talent. The earliest coins were stamped on one side



Wide World Photo

COINING NICKELS—This press stamps heads and tails in one operation.



Wide World Photo

COUNTING COINS—After the nickels have been coined and put through an acid bath, this machine counts them and bags them. They are then ready to be shipped to banks.

only and were easily altered. This led to counterfeiting and cheating. To make it more difficult to counterfeit coins, they were stamped on both sides and the name of the coiner as well as the weight was placed on them. Later still, the practice of making little ridges on the edge of the coins was adopted. This was called *milling*. Milling was used to prevent people from shaving thin strips of metal from the coins thus reducing their weight.

What Are Debased Coins?—At first pure metal was used in coins. It was soon discovered that pure gold and silver wore away too rapidly, and then began the practice of adding a harder metal or mixture. This proved to be a temptation to dishonest traders who began to put less and less pure metal in and more and more alloy. Thus, although the coins weighed the same, they were less valuable. People were not sure when they took coins in exchange that they were getting what they were supposed to get. There was no uniformity in the value of coins of the same size. Some were full weight and some were not.

So much distrust and confusion arose in trade that governments took over the right to coin money and forbade the coinage of money by private individuals. This has made a vast difference. Now all coins are uniform; uncertainty and suspicion have been removed. Although it is still possible to counterfeit coins, it has become more difficult and dangerous.

Coinage Terms.—Government coinage of metal money may be either limited or unlimited. Under a system of limited coinage the government buys whatever amount of any metal it chooses to coin. Under a system of unlimited coinage or free coinage, anyone having a specified amount of a metal may take it to a government mint and have it converted into coin. The word "free" as used does not mean "without cost" to those who bring the metal to be coined. It simply means "without limit as to quantity" that will be accepted for coinage. The United States government makes a charge for purifying the metal and for the alloy that is added: but it does not charge for the labor or for the use of the machines and designs. This is called gratuitous coinage.

How Is Paper Money Engraved and Printed?—The coining of metal money is carried on in three government mints situated in Philadelphia, Denver, and San Francisco; but all paper money is engraved in the Bureau of Engraving and Printing at

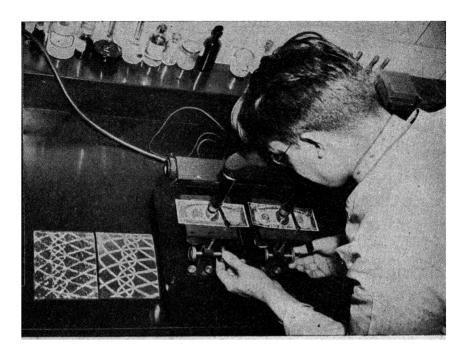


Wide World Photo

\$107,000 A MINUTE—All our paper money is made in the Bureau of Engraving and Printing, Washington, D. C. Here huge piles of one-dollar bills, amounting to \$107,000, are being stacked and checked. Note the War Bonds at the left, which are also printed in Washington.

Washington, D.C. The purpose is to have our currency uniform and dependable. The paper used in making money is very carefully selected, the forms are designed secretly, and the engraving and printing are carefully guarded in order to prevent counterfeiting.

Can You Detect "Phony" Money?—It is claimed that the counterfeiting of minted money began in the days of the Emperor Nero. Since then it has flourished in many countries. In the United States, in spite of the precautions noted above, counterfeiting is still a problem. For that reason it is important that you learn to distinguish good money from bad. This is best done by comparison.



Wide World Photo

BAD MONEY TALKS—This expert is making a comparison test with genuine and "phony" notes. Suppression of counterfeiting is one of the important duties of the United States Secret Service. (This photograph reproduced by special permission of the Secretary of the Treasury. Further reproduction in whole or in part is strictly forbidden.)

Paper Money.—Let us first consider paper money. In the center of a bill there is a portrait of a prominent American. On a genuine bill this portrait is lifelike and distinct. It stands out clearly from the background. On counterfeit bills the portrait is smudgy and dull. Now look at the treasury seal. On a genuine bill the sawtooth rim of the seal has sharp and regular points; on a counterfeit bill the points are blunt and uneven. Finally, notice the paper on which the bill has been printed. Genuine bills are printed on distinctive paper which is heavy and has red and blue threads running through it. The law forbids the manufacture of this paper except by the government. Thus counterfeit paper money is printed on poorer grade paper which does not have the silk threads running through it. Genuine paper money can be distinguished from counterfeit by noting that in every way the genuine shows skilled and careful workmanship while the counterfeit money is poorly made.



A COUNTERFEIT BILL—Use a magnifying glass to compare a genuine dollar bill with this reproduction of a counterfeit bill. The points to look for are given in the text. (This photograph reproduced by special permission of the Secretary of the Treasury, in furtherance of the U. S. Secret Service program of Crime Prevention through Education. Reproduction in whole or in part is strictly forbidden.)

Metal Coins.—Counterfeit coins, like counterfeit bills, are most easily recognized by comparison with genuine metal money. For instance when you drop a good coin, it produces a clear, ringing sound. But when you drop a counterfeit coin, it usually makes a dull sound with no ring to it. Another point of comparison is seen in the edges of the coins. All coins, except the penny and the 5-cent piece, have a corrugated edge, called "milling." On good coins the ridges are distinct and evenly spaced. On counterfeit coins these ridges are irregular. Another factor of comparison lies in the grade of metal used. Counterfeit coins are usually made of softer metals than good coins, so soft that often their edges can be cut with a knife. Finally, if you feel the two types of coins, you will note that the counterfeit coin usually feels greasy.

How Does Money Get into Circulation?—You have probably asked this question many times without receiving a satisfactory answer.

The distribution of paper money and coins is made by the Treasurer of the United States and by the Federal Reserve banks and branches in their respective districts upon application from banks. Stocks of paper money, other than Federal Reserve notes, are supplied to the Federal Reserve banks by the Treasurer of the United States from his reserve stock in the Treasury; coins are supplied to those banks by the Treasurer, who orders the mints to ship them.

When the banks in your community need coins or paper money to supply the demands of local business, they request money from their district reserve bank and have it charged against the balance that they maintain with it. This means that banks draw paper money and coins from the reserve banks in much the same way that a customer draws money from a bank in which he has funds on deposit. The local banks then pay this money out through checks or pay rolls and thus get it into circulation. When some of this money is again deposited, the banks send part of it to the district reserve bank again and the process is continued.

Summary.—Money is anything which is generally acceptable in a community in exchange for all other commodities and services. Money has not always been the coins and paper bills with which you are familiar. Formerly such things as shells, grains, cattle, skins, tobacco, feathers, and base metals, such as iron and tin, were used as money. Each of these, however, was found lacking in some desirable quality and was finally discarded. Some lacked durability, divisibility, and uniformity. Others lacked stability of value. Many were not easy to carry about. Because of these defects, a mere satisfactory money commodity was sought until finally gold and silver became the most commonly used money commodities.

Money performs several functions, the chief of which is to act as a medium of exchange or the go-between in all transactions. It also serves as a measure of value, as a standard of postponed payments, and as a storehouse of value.

In order that people may know the value of the pieces of metal used in trade, designs and values have been stamped upon them. This process is called coinage. It is a very old process and for many years was carried on by private individuals. But there was no uniformity in the coins thus made and no one was sure of what he received when he accepted such a coin. Finally the government assumed the responsibility of coining metal money. Now we are assured of uniform coins; suspicion and uncertainty have disappeared.

Although governments have assumed all coinage rights, there has been a certain amount of counterfeiting going on. This makes it necessary for everyone to learn simple ways of detecting counterfeit money. As a general rule, a counterfeit coin or paper bill can be detected by comparing it with a genuine piece of money. Genuine money is distinguished by its expert and careful workmanship, while counterfeit money is recognized by its careless and poor workmanship.

Metal money is manufactured in three mints, and paper money is engraved and printed in the Bureau of Engraving and Printing in Washington, D.C. Both the coins and the paper money get into circulation in much the same way that a person draws money from a bank in which he has a checking account. Local banks request money from the district reserve bank against a balance that they maintain there. The reserve banks get the money from the Treasurer of the United States, who is responsible for the issuing of all money.

### Questions to Test Your Knowledge

- 1. What is money?
- 2. Why do we need money?
- 3. Name some articles that have been used as money in the past.
- 4. Why were these articles abandoned as money?
- 5. Name and explain the qualities that good money should possess.
- 6. Is gold a perfect money? Why, or why not?
- 7. Name the four chief services performed by money.
- 8. What is hoarding?
- 9. Define coinage.
- 10. Why is coinage now carried on exclusively by our government?
- 11. Distinguish between limited and unlimited coinage.
- 12. How may counterfeit coins and paper money be detected?
- 13. Explain how money gets into circulation.

# Questions for Discussion and Application

- 1. How could such commodities as tobacco and grains serve as money when they lacked so many of the desirable qualities?
- 2. Explain why hoarding on a general scale might be socially and economically harmful. Why do people hoard money?
- 3. Discuss the statement, "There is no perfect money."

- 4. What is the difference between the medium of exchange service of money and the service as a measure of value? Can one exist without the other? Explain.
- 5. Discuss the problems arising out of private coinage of money.
- 6. Is it necessary that money have value? What gives value to a 50-cent piece? to a dime? to a gold coin?

## Floor Talks and Written Reports

- 1. Early history of money.
- 2. The process of making coins.
- 3. How money gets into circulation.

## Topic for Debate

RESOLVED, That private coinage should be restored.

## For Further Information

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Woods, W. O., "The Story of Uncle Sain's Money."

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# Chapter XII

# Our Monetary System

### Aims of This Chapter:

To learn the kinds of money in daily use.

To examine the advantages and disadvantages of paper money.

To see how Gresham's law operates.

To find out what is meant by a gold standard.

In the preceding chapter you learned what money is and what jobs it performs. You also learned why money is needed. At this point it will be interesting and instructive to learn something about the various kinds of money that you use from day to day. You are quite familiar with the metal coins and have no difficulty in telling one from another. But the chances are that you do not know the distinctions made between the several kinds of paper money. This chapter will be devoted to an attempt to explain the various kinds of money in use today.

Metallic Money.—It has been explained that all our metal money is manufactured from bullion at the United States mints. In making metal money the government uses gold, silver, copper, and nickel, alloyed with small amounts of other metals.

Gold Coins.—At one time the United States government manufactured several gold coins but as a general rule they were not desired for use in trade because they contained too much value in small bulk. Gold coins of small denominations were not practicable and, aside from their use by banks, they were used chiefly as souvenirs, prizes or gifts. In 1934, the government ceased to coin gold and these coins no longer circulate.

Silver Coins.—These are made of a mixture of pure silver and an alloy. They consist of the silver dollar, the half dollar, the quarter dollar, and the dime or 10-cent piece. The last three of these coins

are called *subsidiary* coins because they are used to assist in carrying on small transactions.

Minor Coins.—These are made of copper and nickel with a mixture of alloy. They are the penny or 1-cent piece and the nickel or 5-cent piece. There are so many uses for coins of very small denominations that it would not be economical to use silver for this purpose. We once had a silver 3-cent piece, but it was too small to be of practical use and was abandoned. The dime is now the smallest silver coin.

Token Coins.—All the silver coins as well as the penny and the nickel are sometimes called token money because they contain less than the face value of the metal in them. That is, there is less than 50 cents worth of silver in a half dollar, and even the silver dollar is not worth \$1 in silver. The same is true of all the other coins. All of them are worth more in exchange for goods than they are as metal.

What Is Standard Money?—Nearly every country uses as money certain metal coins and paper notes. But, regardless of the number or kinds used, there is usually one form of money that sets the standard for all the rest. This is called "standard" money and is defined as a quantity of metal (usually gold) of specified weight and fineness, the bullion value of which exactly equals its value as money. Thus standard money gets its value from the value of the metal of which it is made and not from any stamp that the government may place upon it. Measured by the above definition, gold constitutes the only strictly standard money in our country. Silver dollars, although they were once standard, and are still called by that name, are greatly underweight and so also are all subsidiary coins. Paper money, in spite of the fact that it will be accepted in exchange, possesses almost no value as a commodity. The gold certificate, even though it is virtually a receipt for gold that is actually held in the Treasury, is at present inconvertible and thus is not standard money.

In the United States the gold dollar is the standard money unit. Prior to 1934 the gold dollar contained 23.22 grains of pure gold and was our standard coin. But in 1934 this standard was changed and the gold dollar now contains 13.71 grains of pure gold. As just stated, gold coins were removed from circulation in that year.

There Are Several Kinds of Paper Money.—Since we have metal money of denominations that serve all our purposes, why do

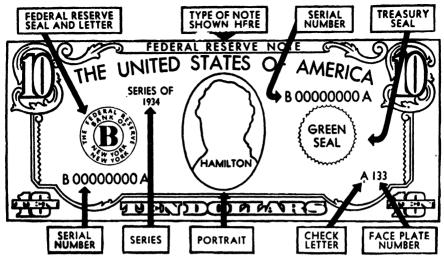
we have paper money? There are two very good reasons why paper money is made and circulated. One of these is the cost. It is much cheaper to make a one-dollar bill than to make ten dimes or a dollar's equivalent in any other coins. The other reason is that paper money is much more convenient to carry about. It is much easier to carry a few paper notes which can be folded into a small space than it is to carry a large number of coins. The smallest paper bill is the one-dollar note. We once had paper in small denominations, but it did not prove to be practicable.

Paper money is of two types: representative and credit.

Representative Paper Money.—This type consists of certificates which represent a specified amount of metal money, once gold or silver. They circulate in place of the metal itself and are like warehouse receipts. The government holds the metal and will give it to the holder of the certificate if he desires it. Before 1934 we had two kinds of representative paper money: gold certificates and silver certificates. Since that date, the gold certificates have been called in and individuals are no longer permitted to have them. Only Federal Reserve banks are now allowed to hold them against gold taken from them by the United States government and deposited in the Treasury. A silver certificate, as its name implies, is redeemable in silver. If you examine a one-dollar silver certificate, you will note that it says, "This certifies that there is on deposit in the Treasury of the United States of America one dollar in silver payable to the bearer on demand." At the top in the center are the words "Silver Certificate."

Credit Paper Money.—This type of paper money is issued by the government and by the Federal Reserve banks. They are promissory notes which circulate as money. They are accepted by the people as long as they have faith in the ability of those who issue them to redeem them in something of value which is equivalent to the amounts promised in the notes. This kind of money does not represent actual metal which has been put away to redeem it. If you will look at a five-dollar United States note you will see that it says, "The United States of America will pay to bearer on demand five dollars." If it is a bank note, the bank issuing it makes the promise, although the government stands ready to make the notes good in case the bank fails to do so.

At one time five kinds of credit paper money were issued but only two of these are now in general circulation. Treasury notes of 1890 to



FEDERAL RESERVE NOTE—This diagram shows the position of important features of a Federal Reserve note. Study the paper currency in circulation and know your money. (Used by special permission of the Secretary of the Treasury; further reproduction in whole or in part is strictly forbidden.)

the extent of about 1¼ million dollars still exist but are chiefly in the hands of money collectors and are of no interest to us. National bank notes were issued by the various national banks until 1935. Since then they are being retired and their place is being taken by other paper money. Although you may see some of these bank notes, they are fast disappearing from circulation. Federal Reserve bank notes have been used chiefly as an emergency money and are not found in general circulation.

The two kinds of credit money in common use today are the United States notes and the Federal Reserve notes.

United States notes are noninterest-bearing notes which the national government promises to pay to bearers on demand. When these notes were first issued during the Civil War, they were printed in a green color on the back and became known as "greenbacks." At that time they had no security behind them except the faith and credit of the government. But in 1879 the government agreed to redeem them in gold on demand. In 1900 a special fund of 150 million dollars was created for the redemption of these notes. There are about 346 million dollars of them in existence.

Federal Reserve notes make up the largest part of the credit paper money in circulation today. They are liabilities of the Federal Reserve banks that issue them, but they are also guaranteed by the United States government. Federal Reserve notes are backed by the pledge of collateral, which consists of rediscounted commercial paper, that is, the promissory notes of customers of the member banks. Finally, Federal Reserve notes are also secured by at least 40 per cent in gold certificates (formerly gold itself). It is these notes which, as we shall see later, give elasticity to our currency, since they can be increased or decreased in quantity with the needs of business.

Some Paper Money Is Inconvertible.—It sometimes happens that governments issue a kind of paper money which is a promise to pay but which is not redeemable immediately in specie. It circulates only by the authority of the government. It is used because the people have no better money and because the government is strong enough to make people accept it. It is usually issued in times of emergency, such as wars, or when there is great difficulty in raising money by the usual methods of taxation and loans.

Has Paper Money Any Advantages?—We have already stated the reasons for paper money but we may repeat them here and add to what has already been said. If there were no advantages in paper money, it is not likely so much would be issued. What are these advantages?

- 1. Paper money is the cheapest form of money that is issued. It costs no more to make a \$1000 bill than a \$1 bill.
- 2. These paper notes bear no interest and thus the government obtains a large sum of money without this expense.
- 3. Paper money is more convenient to handle than metal money. It can be stored away and carried about with great ease.
- 4. When metal coins are used, they wear away in time and are in constant need of replacement. Although paper money also wears out, it costs much less to replace it and therefore saves loss that would result from the more common use of metal.

Paper Money Has Serious Disadvantages.—The advantages of paper money are important. But you should not overlook the fact that some of these advantages often lead to serious disadvantages. Here are two common disadvantages.

1. Because paper money is cheap and easy to print, quantities of it are printed and circulated before it is realized what damage has been done. We have had examples of this in our history. During our Revolutionary War so much paper money was issued by the Continental Congress that it became worthless, giving rise to the expression "not worth a continental." When the greenbacks were first issued during the Civil War, they dropped in value to such an extent that a paper dollar was worth only 35 cents. During the First World War and for several years after, several European countries issued so much paper money that it soon lost all its value and people suffered loss.

2. When paper money has been issued in such quantities that its value declines, it causes hardship to those who are on fixed incomes and to creditors. Excessive issue of paper money results in rising prices and declining purchasing power for large groups of people. This is inflation. Goods are scarce and dear, but money is plentiful and cheap.

**Several Monetary Systems Exist.**—Throughout history two monetary systems have been commonly recognized and used. These are monometallism and bimetallism.

Monometallism.—This is a system under which the standard is composed of one metal, usually gold. This was the system under which the United States operated for many years before 1933. Gold was the basis of our money system and we were said to be on a gold standard. The gold standard is characterized by the following: (1) The standard unit is the gold dollar. (2) Gold may be coined in unlimited quantities. (3) Gold is full legal tender, that is, it may be offered as payment for all debts. (4) All other kinds of money are convertible into gold. (5) Gold can be melted down or exported at will.

Before 1914 practically all the countries of the world were on a gold standard. The First World War caused nearly all the countries except the United States to abandon the gold standard. After the war several countries returned to the gold standard but the depression that began in 1929 forced them to abandon it again. The United States itself gave up the gold standard in 1933 so that no country today is on a real gold standard.

Bimetallism.—This is a system under which the standard unit is expressed in terms of two metals, usually gold and silver; in which there is unlimited coinage of both metals and both are full legal tender. When such a system is established, it becomes necessary to determine upon a ratio to express the relative values of the two metals when they are coined into money. This is called the *mint ratio*. This ratio is established by Congress and is fixed. But gold and silver are

also used as metals in the fine arts and as such are bought and sold in the market like other commodities. This means that there is a *market ratio* which expresses the relative values of the two metals when they are so used. The market ratio is determined by the laws of supply and demand and is not fixed.

The difficulty with bimetallism is to make the mint ratio and the market ratio correspond. If they are equal, either metal will be coined and bimetallism will really exist. But this seldom happens because the market values of gold and silver are constantly changing. Because the market ratio varies while the mint ratio is fixed, it is practically impossible to maintain a bimetallic standard for very long. If, under a bimetallic standard, the market ratio were 15 to 1 and the mint ratio were 16 to 1, gold would be brought to the mints to be coined while silver would be melted down and exchanged for gold. All debts would be paid in gold, and gold would soon be the only circulating medium.

If the market ratio changed to 17 to 1 while the mint ratio remained at 16 to 1, silver would be overvalued at the mint. Debts would now be paid in silver, gold would be melted down, and only silver would be coined into money. In either case, actual monometal-lism has existed with first gold and then silver predominating. The metal that is overvalued at the mint will drive the other out of circulation.

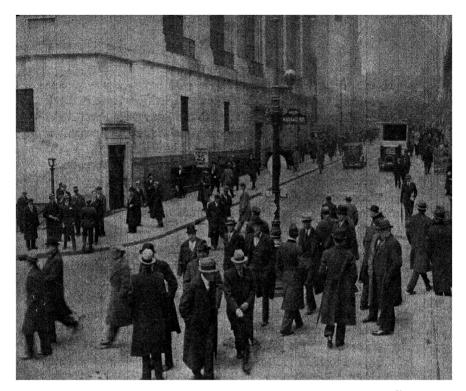
Bad Money Drives Out Good Money.—This tendency of money that is overvalued at the mint to drive out of circulation money that is undervalued, is known as Gresham's law. It is stated as follows: Bad, cheap, or overvalued money tends to drive out of circulation the good, dear, or undervalued money. The operation of this law has been illustrated many times in past history. The continental paper money drove out of circulation the gold and silver. The greenbacks drove out gold and silver after the Civil War.

Changes in Our Monetary System.—The United States was on a bimetallic standard legally until 1863. It was not a real bimetallic standard in practice because first gold displaced silver and then silver displaced gold. From 1863 to 1879 we were on a paper money basis. People began to hoard gold. Banks suspended specie payments; that is, they refused to make payments in hard money. Even the Federal government ceased to make payments in specie. Nearly all coins disappeared from circulation and only paper remained. During



Courtesy of New York Times and Acme Photo

BANK HOLIDAY—The news printed above tells of three days that shook a nation. Many believed that as soon as the banks reopened there would be a rush to them by depositors to draw out their money.



(Acme Photo)

BANKS REOPEN—Instead of rushing to draw their money, as had been feared, thousands of people journeyed to New York banks to deposit, as they reopened after the holiday, on March 13, 1933. This scene shows the crowds on Wall Street, going about their business as usual.

this period the owners of silver mines made several attempts to have silver restored to its place beside gold.

The silver dollar declined in value until it was worth only 72 cents in 1889. Congress passed the Bland-Allison Act and the Sherman Silver Purchase Act in an effort to change conditions. But they were soon repealed as gold was rapidly driven from circulation. In 1896 a bitter campaign was waged over the silver question, and an effort was made to restore bimetallism. The advocates of gold won, and in 1900 Congress passed an act by which the United States became a gold standard country.

Gold Standard Abandoned, 1933.—Because of the serious banking emergency, the President closed all banks in the country in 1933. By proclamation he placed an embargo on the export of gold and silver except under special license; he prohibited banks and the Treasury from paying out gold and silver. An Emergency Banking Act in March, 1933, confirmed these measures and authorized the

President to stop all private hoarding of gold and to require all gold coin, bullion, and gold certificates to be exchanged for other kinds of money. The Thomas Amendment to the Emergency Farm Relief Act of 1933, authorized the President to reduce the gold content of the dollar up to 50 per cent; to establish a bimetallic system of gold and silver; and to issue 3 billion dollars' worth of United States notes. The President has exercised only the first one of the authorities granted him. The gold dollar was depreciated and then removed from circulation. The United States went from the gold standard to a paper standard.

Gold Reserve Act and Proclamation of 1934.—These two measures had an important effect on our monetary system. By them gold became the property of the United States government, and the entire stock is held by the Treasury. Gold is no longer coined. For uses in industry and in international trade, gold bullion is obtained in return for other money under a license system. By proclamation the President changed the gold content of the dollar from 23.22 grains of pure gold to 13.71 grains. In other words, he reduced the content of the gold dollar 40 per cent. This is called devaluating the dollar. The President also set a new price for gold. Where it had formerly been \$20.67 an ounce it is now \$35 an ounce.

Silver Purchase Act of 1934.—In spite of these efforts to bring better prices and to relieve those who were in debt, people were not satisfied and another demand was made to cheapen the currency further. Pressure was brought to bear to have silver placed on a better standing. Finally, Congress passed the Silver Purchase Act. This made silver the property of the national government. All who had any silver bullion were ordered to sell it to the government at 50 cents an ounce. The act further stated that the United States would continue to buy silver until the stock of that metal should equal one-fourth of the monetary value of the gold. It was expected that the government would immediately build up its monetary stock so that it would consist of one part silver to three parts gold. But since the law permits the President to use his discretion, the law has not had the desired effect. About the only result has been to increase the governmental stock of silver and to raise the price of silver bullion.

Summary.—United States money is made of metal and paper. Gold coins are no longer in use and are not coined; but copper, nickel, and silver coins are in common use. Paper money is issued

by the government and by the Federal Reserve banks. This paper money is of two kinds: representative and credit. Representative paper money is secured dollar for dollar by gold or silver deposited in the Treasury. As gold certificates are no longer in use except by Federal Reserve banks, silver certificates are our only representative money.

Credit money issued by the government is backed by a partial gold reserve and partly by commercial paper. United States notes are the only form that now circulates. When issued by banks credit money is in the form of Federal Reserve notes and Federal Reserve bank notes, the latter being only emergency money and not in general usc. National bank notes have not been issued since 1935.

Paper money is used to a large extent because it is convenient and easy to carry about and because it saves the wear on precious metals. It is also a cheap way of issuing money; it enables the government to borrow money without paying interest. The danger is that too much may be issued. This reduces its value and causes injustices to many groups of people. Moreover, paper money is not accepted in international trade.

When the monetary standard of a country consists of one metal, usually gold, the country is said to be on a gold standard. The United States was on such a standard until 1933. Since then our standard has been what is called a gold bullion standard; it is really a paper standard because the precious metals cannot be had for the paper money. When the money standard is composed of two metals, each of which is subject to unlimited coinage and each of which is full legal tender, it is called a bimetallic standard. The bimetallic standard is supposed to give greater stability of value, but it has proved difficult to make the mint ratio and the market ratio correspond, with the result that first gold drives silver out of circulation and then silver drives out the gold. This is due to the fact that the mint overvalues one or other of the metals. When overvalued money drives undervalued money out of circulation, Gresham's law is operating.

Since 1934 there have been several important changes in our monetary system. The gold standard was abandoned in 1934, and the content of the gold dollar was reduced about 40 per cent. Moreover, no one was permitted to possess gold beyond a small amount. The price of gold has been raised from \$20.67 to \$35 an ounce. Silver has likewise been nationalized so that today we have what is known as a managed currency in the United States.

## Questions to Test Your Knowledge

- 1. What is subsidiary money?
- 2. Explain what is meant by token money.
- 3. Define standard money. What is the standard unit in the United States now?
- 4. Define and give examples of representative and credit money.
- 5. How does fiat money differ from other kinds of paper money?
- 6. Why do people accept fiat money?
- 7. State the advantages of paper money. What are its disadvantages?
- 8. What is meant by monometallism?
- 9. State the conditions necessary to have a gold standard.
- 10. Explain what is meant by bimetallism.
- 11. Distinguish between a mint ratio and a market ratio.
- 12. Why is it difficult to maintain a bimetallic standard for long?
- 13. State Gresham's law. Give an example of how it operates.
- 14. What changes did the Gold Reserve Act of 1934 make in our money system?
- 15. What is meant by the nationalization of gold and silver?

## Questions for Discussion and Application

- 1. Discuss the changes that have taken place in our standard money since 1792. Have we any real standard money today?
- 2. Discuss the conditions under which a gold standard is said to exist How can silver coins circulate in such a system?
- 3. Show that it would be difficult, if not impossible, to keep a mint ratio the same as the market ratio. Use an example of your own to prove your point.
- 4. The United States was legally on a bimetallic standard from 1792 to 1863. But during that time we never actually had bimetallism. How do you account for this apparent contradiction? Discuss.
- 5. What were the purposes behind the monetary changes in 1934?
- 6. Discuss the terms of the Gold Reserve Act of 1934.
- 7. What are the possible implications of the Silver Purchase Act of 1934?

## Floor Talks and Written Reports

- 1. The need for an elastic currency.
- 2. The silver controversy.
- 3. Bimetallism versus monometallism.

## Topic for Debate

RESOLVED, That bimetallism should be restored.

### For Further Information

Angell, Norman, "The Story of Money."

Cole, G. D. H., "What Everyone Wants to Know about Money."

Gemmil, P. F., "Fundamentals of Economics," Chap. 12.

Hayes, H. G., "Inflation. What Is the Gold Standard?"

Kemmerer, E. W., "Money."

Public Affairs Pamphlets, "How Money Works," No. 45; "More for Your Money," No. 63.

Public Policy Pamphlets, "Should We Turn to Silver?" No. 6; "Devaluation of the Dollar," No. 8.

# Chapter XIII

# The Changing Value of Money

### Aims of This Chapter:

To define "value" as applied to money.

To learn how price changes are measured.

To note how price changes affect various groups.

To examine plans for lessening the evils of price changes.

In the United States and their characteristics. So far nothing has been said about the value of money. Since this is a very important characteristic of it and affects everybody seriously, it will be necessary to devote a chapter to its consideration.

What Is Meant by the Value of Money?—Value has been defined as the worth of a thing in terms of other things. When this value is expressed in terms of money it is called "price." All commodities except money have a price. Money has no price because you cannot exchange money for money and have it mean anything. Money is the unit in terms of which all prices are expressed. Its value is determined in very much the same way that the value of other commodities is determined. By value of money is meant its purchasing power or its power to command other goods in exchange.

When the dollar purchases more of other goods, its value has increased; when it purchases less of other goods, its value has decreased. To state this in another way, when the purchasing power of money is rising, it means that prices are falling; when the purchasing power of money is declining, it means that prices are rising. Thus changes in the value of money are registered in the general level of prices. The higher the price level, the lower is the purchasing power of money and vice versa. By general price level is meant the average of a large number of prices.

How Are Changes in Price Levels Measured?—To measure changes in the general price level, an index number is used. Index numbers are percentages that express relative changes, such as differences in general prices in two or more years.

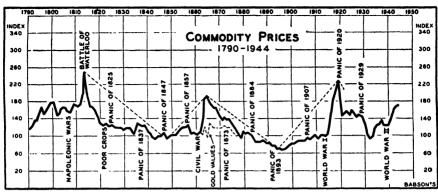
When we wish to consider changes in the price of a single commodity at various times, it is not necessary to have an index number. But when the prices of many articles are being considered, there are likely to be many variations. The prices of some articles may have risen while the prices of other articles may have dropped. It is possible that the prices of some articles may remain the same over a period of time. In order to measure the changes in the prices of many articles index numbers are needed.

How Are Index Numbers Made?—Before you try to construct an index number, you must decide what prices you are going to compare. If you are interested in studying the changes in the price of food, you will need to assemble only the prices of foodstuffs. If you wish to compare changes in the entire cost of living, however, you will then need to assemble the prices of many articles, such as foods, clothing, light, fuel, household furnishings, and all other articles that enter into your usual living expenses. It should be pointed out that the more prices you use, the more accurate will be the index number.

Wholesale prices are usually used because it is easier to obtain accurate wholesale prices than accurate retail prices. Moreover, wholesale prices vary less throughout the country than do retail prices. But wholesale prices are likely to change more suddenly and sharply than retail prices.

To show the manner in which an index number is found we shall use the wholesale prices of several articles in common use adapted from the tables compiled by the United States Bureau of Labor Statistics. The year 1926 has been chosen as the base year and the year 1940 is to be compared with it. We shall use only six prices for our purpose since we are desirous only of seeing how the index is found. Examine carefully the table on page 190.

The individual prices for 1926 are added and to this total is given a rating of 100 per cent. Then the individual prices for 1940 are added and this total is compared with the total prices for 1926. Dividing the total prices for 1940 (\$1.03) by the total prices for 1926 (\$1.25), and multiplying by 100, you get the index number of 82.4 per cent for 1940. This means that as far as these six articles are



Courtesy of Babson's Statistical Organization, Inc.

COMMODITY PRICES—This graph shows the change in commodity prices from 1790 to 1944.

concerned, there has been a decline of 17.6 per cent. A 17.6 per cent drop in prices indicates an increase in the purchasing power of money with respect to the commodities listed. It means that the purchasing power of the dollar in 1940 was 100/82.4, or about 121.4 per cent of its purchasing power in 1926. In other words, a decline of 17.6 per cent in the general price level is equivalent to an increase of 21.4 per cent in the value of money.

Commodity	1926 unit price	1940 unit price
Eggs (dozen)	\$0.34	\$0.28
Butter (pounds)		0.35
Coffee (pounds)	0.18	0.12
Sugar (pounds)		0.05
Beef (pounds)		0.14
Bread (loaf)	0.08	0.09
Total prices	\$1.25	\$1.03
Unweighted indexes	100%	82.4%

This method of finding an index number is not accurate, because not enough articles and prices have been used. In order to approach accuracy, the prices of hundreds of articles should be used. Moreover, all the articles are not of the same importance; changes in the price of one are not of equal weight with changes in the price of others. If this fact were taken into consideration, we should then have a weighted index number, which would be more truthful and more representative of conditions.

The United States Bureau of Labor Statistics uses about 784 articles whose prices are based on reports from cities all over the United States.

Price Changes Have Serious Effects on Everyone. Changes in the general price level are of serious consequence to all classes of people; debtors and creditors, businessmen, wage earners, salaried workers, those on fixed incomes, and consumers in general. When the gencral price level rises,



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#### ADVANTAGES OF INFLATION

What does the above cartoon teach about the changes in purchasing power of money?

as it often does in a period of good times or in a time of war when goods are scarce, every individual finds himself paying more money to obtain the goods he needs. In other words, his income has less purchasing power. But when the general price level drops, as in periods of hard times, his money buys more if he is fortunate enough to have the same money income. Let us explain more in detail how various groups are affected by changes in the general price level.

Debtors and Creditors.—The most marked effect of changes in purchasing power can be seen as between the debtor and creditor classes. When money is borrowed or lent, it is really purchasing power which is borrowed or loaned. If a man borrowed \$100 in 1926 with the purchasing power of the dollar at 100 per cent and repaid the loan in 1940 when the purchasing power of the dollar was 82.4 per cent, the creditor would have suffered a loss. He lent \$100 of purchasing power; and although he received back \$100, it had only 82.4 per cent

of the purchasing power lent. On the other hand, if the loan had been repaid in 1933 with the purchasing power of the dollar at 110 per cent, the debtor would be repaying more purchasing power than he had borrowed. This indicates that debtors gain by paying their debts when prices are high and lose by paying when prices are low. Creditors gain by a decline in prices provided the decline does not make it impossible for the debtors to make repayment.

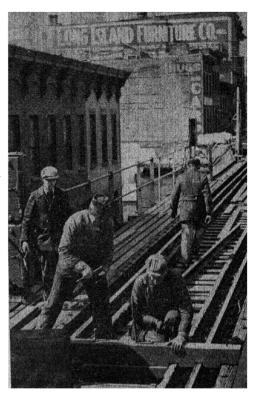
Those on Fixed Incomes.—Those who live on incomes that are fixed are seriously affected by rises in the price levels. A person who has retired from active work and is living on interest from bonds or on an annuity or pension, finds that a rise in prices means that he is able to buy less goods than before. His income remains the same regardless of changes in prices. When prices fall, he is better off because he is able to buy more goods.

Salaried Workers.—Whereas salaried workers are affected in much the same way as creditors, such as bondholders, they are not affected quite so seriously. Teachers, office workers, government employees, and many others are paid according to a contract between them and their employers. This contract is usually made for a year and is changed only at the end of the period. If prices change during the period of the contract, these salaried workers have their incomes either reduced or increased in purchasing power. Other salaried workers who are paid monthly, but not according to a contract, may have their salaries changed, but they seldom are changed as rapidly as prices rise. Salaried workers are worse off in a period of rising prices than they are in a period of falling prices, provided they hold their jobs. Prices often go up the elevator, while wages slowly climb the stairs.

Wage Earners.—By wage earners we mean those skilled workers and laborers who are usually paid on a weekly basis. Many of these workers receive income which is the result of collective bargaining. Many wage earners belong to unions bound by wage agreements which last for six months or a year. Thus the earnings of wage earners are more likely to keep pace with rising prices than are the earnings of those on salary. But even though this may be so, wage increases lag behind rises in prices. Should a rise in prices occur while the wage agreement is in effect, the wage earner loses in purchasing power represented by his fixed wage. On the other hand, if prices drop too low, the worker may suffer a cut in wages or may even lose his job. Thus he may suffer from either rising or falling prices.

Businessmen.—Manufacturers and merchants like to see a period of rising prices because it usually means higher profits for them. Although rising prices in general will cause their costs of making and selling goods to rise, they do not ordinarily rise as fast as the selling price of the finished prodnet does. But businessmen are equally liable to meet with a loss when prices drop, because they have produced their goods at a time when wages and other costs were high and must now sell them at a time when prices are below their cost of production.

Can Changes in Price Levels Be Controlled?—From what has just been said about the effects of price changes upon various economic groups, it should be clear that grave injustice and great inconvenience are caused thereby. For some time economists have been studying this problem of price changes; they have made



International News Photo

WAGE EARNERS—These workmen on an elevated railroad may suffer from either rising or falling prices. They are generally paid weekly at a fixed rate per hour.

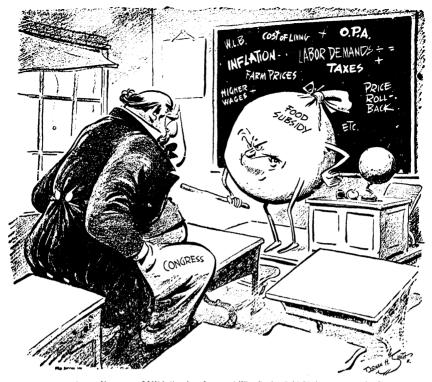
several suggestions for checking the "dizzy dance of the dollar." Some plans are quite technical and difficult to understand. It may be possible, however, to explain simply and briefly some of the better known proposals.

Stabilized Dollar.—Professor Irving Fisher, formerly of Yale University, is the sponsor of the stabilized dollar or commodity dollar. He would reverse the situation as it has existed for years. At present the weight of the gold dollar is fixed while its purchasing power fluctuates. Professor Fisher would have the purchasing power of money fixed and the weight of the gold dollar fluctuate. According to his plan no gold would be coined, the metal would be kept in gold bars, and only representative money would circulate. All paper money

would be exchangeable for gold on demand, but the amount of gold for which it would exchange would vary with the price level. For example, if prices, as measured by an index, fell 1 per cent during the month, the weight of the gold dollar would be decreased 1 per cent and vice versa. There are so many difficulties in this plan that it has never been tried over a sufficiently long period of time to test it. It would be difficult to obtain an accurate index that would be approved by all; it would involve so much bookkeeping that it does not seem practical. Nevertheless, as we have seen, President Franklin D. Roosevelt did devaluate the dollar by reducing its gold content in an attempt to check, or to raise, falling price levels.

Control of Credit.—The plan just explained is based upon payments in money redeemable in gold. It does not take into consideration the fact that about 90 per cent of all business in the United States in normal times is done on a credit basis. This has led some economists to suggest a plan to stabilize prices through the control of credit. Much of our credit is extended through the rediscounting process provided by the Federal Reserve System, which permits member banks to receive additional credit or Federal Reserve notes by giving commercial paper as security, that is, by pledging the promissory notes of their own borrowers. By lowering or raising the rediscount rate, the Federal Reserve System can encourage or discourage reborrowing by member banks. This will, in turn, encourage or discourage borrowing by their own customers through lowering or raising their own rates of bank discount or interest charges. In this way the Federal Reserve System can to some extent control the interest rate and the amount of credit existing. The plan suggested is as follows: If the general price level begins to rise above a point which the Board of Governors of the Federal Reserve System regard as normal, they can raise the rediscount rate. This will tend to reduce credit and bring the price level down. On the other hand, if the price level drops below the point which the Board regards as normal, they can lower the rediscount rate. This will encourage the demand for more credit and tend to cause a rise in the price level.

Though this plan sounds practical, there are many difficulties involved. For one thing there are many who hesitate to place so much power in the hands of the Board of Governors. For another thing it would be difficult to arrive at an index number that would satisfy all groups involved. Finally, the control of the interest rate does not



Courtesy of NEA Service, Inc. and The Springfield Union, cartoon by Dorman Smith

CLASS IN ECONOMICS WILL COME TO ORDER—Congress, too, has homework to prepare. What economic problems are being assigned to Congress in this cartoon? How many of these problems can you explain? How will their solution affect our future welfare?

always achieve control of the price level. Governors of the Federal Reserve System regulate the rediscount rate but not the price level.

Price Control in Wartimes.—When we entered the Second World War, many changes were brought about in our economic life. Billions of dollars were spent for war supplies and millions of men and women were employed in war industries. Wages were higher than ever before and people had quantities of money to spend. But because of the needs to produce war goods, civilian goods were greatly reduced in amount and many were not produced at all. The problem of what to do with the excess purchasing power of the workers became acute. If economic laws of demand and supply were left to take care of themselves, prices would rise to unreasonable heights. Some would be able to purchase goods while they lasted and others would have to go without.



Wide World Photo

CEILING PRICES—During the Second World War the Federal government placed ceiling prices on certain goods. The picture above shows a woman comparing the price asked for the canned goods with the ceiling price, which had to be plainly posted. Ceiling prices were established for about 30,000 items.

Under these conditions the Federal government adopted a program intended to hold prices down and thereby avoid the evils of inflation. Price ceilings were established; that is, limits were set above which prices could not legally be raised. These price ceilings applied to about 30,000 items and to rents. At the same time wages were fixed as of a certain date. Raises could be granted by the War Labor Board only to those who could prove that their purchasing power was not sufficient to maintain a decent standard of living. Another step was taken to maintain prices through rationing. Scarce and essential articles were rationed in order to enable everyone to have a fair supply of them. Among these were sugar, shoes, meat, butter, canned goods, fuel oil, and gasoline.

On the whole the plan worked successfully although there were many so-called "black markets," which sought to take advantage of the existing scarcity and rationing to supply goods to those who were willing to avail themselves of this questionable source.

Although prices rose a little because some ceilings were changed, the general price level was fairly well maintained. Such a plan might work well during a war but it is doubtful if people would submit willingly to such a plan in time of peace.

Summary.—The relation that exists between value and price in connection with money is of interest and importance to everyone. Money has value but no price. The value of money is expressed by its purchasing power. When general prices rise, the purchasing power of money grows less; when general prices decline, money has greater purchasing power.

These changes in purchasing power are measured by index numbers. There are several systems of index numbers; but the one used

by the United States Bureau of Labor Statistics based on the wholesale prices of several hundred articles serves best for common purposes.

Everyone is interested in what his money will buy. All groups are affected in some way by price changes. Creditors gain by a decline in prices and suffer by a rise in prices; debtors gain by paying their debts when prices are high and lose by paying when prices are low. All persons on a fixed income are at a disadvantage when prices are rising but have an advantage when prices are declining. Salaried workers and wage earners are affected in much the same way as those on a fixed income but not so seriously. Businessmen gain when prices are rising but may lose when prices decline.

Because serious consequences have always resulted from changes in price levels, many suggestions have been made to lessen the evils. One plan



Wide World Photo

RATIONING—In order to maintain prices, in addition to establishing ceiling prices, the Federal government set up a system of rationing. By this a certain number of points, which consisted of stamps and/or coupons, had to be given for certain items purchased. This housewife is figuring the number of points she must give for her purchases.

would change the amount of gold in the dollar from time to time, in order to keep its purchasing power relatively stable. Another plan would require the Board of Governors of the Federal Reserve System to control price changes through the manipulation of the rediscount rate.

During the Second World War the Federal government put into effect a plan for controlling prices and wages in order to avoid inflation, which worked fairly successfully. Ceilings were placed on the prices of thousands of articles of everyday use, and many articles were rationed. Wages were also fixed to a degree, and raises were permitted only with the sanction of the War Labor Board. Whether such a plan to reduce the evils of fluctuating prices would continue to succeed in time of peace cannot be determined as it has not been tried.

## Questions to Test Your Knowledge

- 1. What is meant by the value of money?
- 2. What is an index number?

- 3. How are index numbers used?
- 4. Show how changes in price levels benefit creditore debtors.
- 5. Why are wage earners at a greater disadvantage than others when prices advance? Illustrate.
- 6. What is meant by the general price level?
- 7. Name two suggestions that have been made to lessen the evils of price changes.
- 8. Explain Professor Fisher's plan.
- 9. What efforts were made during the Second World War to keep prices from rising unduly?
- 10. Explain how rationing gives everyone an opportunity to obtain a fair share of available goods.

# Questions for Discussion and Application

- 1. "The value of money varies inversely with the general price level." Explain and illustrate this statement.
- 2. If a person borrows money when prices are low and repays the loan when prices are high, does he gain or lose by the change in price levels? Explain.
- 3. When prices are rising, what groups gain and what groups lose? Are these gains and losses equitably adjusted as prices fall? Discuss.
- 4. Is the wage earner or the salaried worker the more favorably situated when general prices are rising? when prices are falling?
- 5. List the various efforts made to stabilize prices and wages during the Second World War and discuss the success of these efforts.
- 6. Explain the principle underlying rationing of scarce goods. Why do some people object to rationing?
- 7. What causes black markets? Show that they are a social and economic evil.
- 8. Since changes in price levels tend to create social unrest, would you favor the permanent fixing of prices and wages? Discuss.

# Floor Talks and Written Reports

- 1. Speculation and changing price levels.
- 2. Credit control as a price stabilizer.
- 3. OPA and price control.

## Topic for Debate

RESOLVED, That Federal control of prices and wages should become permanent.

### For Further Information

Fisher, Irving, "The Purchasing Power of Money."

Fisher, Irving, "Stabilizing the Dollar."

Gayer, A. D., "Monetary Policy and Economic Stabilization."

Kemmerer, E. W., "The A B C of Inflation," Chaps. IX-XII.

Mills, F. C., "The Behavior of Prices."

Mitchell, W. C., "Making and Using Index Numbers."

Public Affairs Pamphlets, "Your Income and Mine," No. 20; "How Money Works," No. 45.

Public Policy Pamphlet, "The Commodity Dollar," No. 26.

### PROBLEM 16

### Price Levels and Fixed Incomes

After working many years for a large corporation, Thomas Hardworker retired in 1940 on a pension of \$60 a month. In addition to this pension he received a social-security benefit of \$54 a month. He had been thrifty and purchased an annuity which now began paying him \$30 a month. He has no dependents but must pay for board and room and his other needs out of his income. Now that he has to watch his expenditures and can earn no extra money, he finds that at times he is better off than he is at other times. When prices rise, he notes that he has to cut down on some of his expenditures and enjoy fewer comforts than before.

- 1. Does Mr. Hardworker realize that his income is subject to changes in purchasing power?
- 2. If so, what reasons do you suppose he gives for the change?
- 3. Can he do anything to protect himself from a loss in the purchasing power of his income?
- 4. Do you think that changes in the purchasing power of incomes that are fixed will tend to discourage savings and investments?

#### PROBLEM 17

### An Unweighted Index Number

A family of four persons living in a Western city finds that its income does not go so far in some years as in others. They are told that the cost of living has risen over a period of years and that is why they are not so well off. Taking into consideration the prices of the following articles which this family buys, construct an unweighted index number to show to what extent the price level has changed from 1936 to 1940.

Commodity	1926 price	1940 price
Eggs (dozens)	\$0.33	\$0.36
Butter (pounds)	0.40 0.30	0.42 0.34
Tea (pounds)	0.35 0.18	0.36 0.23
Coffee (pounds)	0.15	0.23

Interpret your new index number in terms of relative purchasing power.

# Chapter XIV

# Credit and How It Is Used

### Aims of This Chapter:

To define credit.

To learn the purposes of credit.

To discuss the advantages and disadvantages of credit.

To examine several kinds of credit.

To see how personal credit is used.

You have now learned something about two systems of exchange. These are barter and money. The barter system proved unsatisfactory because of its great inconvenience; it was replaced by the money system. The money system is still in daily use. But with the increase in the amount of business and the change in the method of conducting business, a new system became necessary. This is known as the "credit" system. It will be the subject of this chapter.

What Is Credit?—Very few people pay cash for everything they buy today. Rent is paid at the end of the month or in advance; the radio and the automobile are paid for in installments; the doctor and the dentist are paid after they have rendered their services. In all these cases someone has received what was wanted but has postponed payment for the commodities and services. Credit is receiving something of value now for a promise to pay for it in the future.

Upon What Is Credit Based?—Credit could not exist if it were not for certain conditions that are present. The primary condition that must exist in every credit transaction is *confidence* on the part of the persons concerned. The person who sells an article or renders a service must have confidence in the person to whom he sells—confidence that the payment will be made.

Another essential condition is the willingness of people who receive goods now to pay for them later. This implies character. A person who succeeds in obtaining goods upon his statement that he will pay



Courtesy of Library of Congress Appearance and position affect materially the credit standing of a person in a community. Would you have confidence in the ability of this man to pay at a future date for something received now?

for them later and then fails to meet his obligations, finds it difficult to obtain further credit. Willingness to pay for what is purchased is an important essential in credit.

A third essential for credit to exist is ability to pay. Whereas credit is often extended to those who do not have much money or property, some arrangement is made whereby a claim is held on the thing sold until it is fully paid for. Thus ability of some sort always exists in a credit transaction.

These three essentials are often referred to as the three C's of credit: confidence, character, and capacity.

**Purposes of Credit.**—Credit is extended for two purposes: for

uses in production and for satisfying personal needs.

Productive Purposes.—When a manufacturer borrows a sum of money from a bank in order to purchase raw materials for use in producing a finished article or when he borrows money to purchase a new machine or to enlarge his plant, he has made use of credit for productive purposes. This is a very common use of credit today.

Satisfying Personal Needs.—When an individual buys a house, a refrigerator for the home, or an automobile for personal use, agreeing to pay for it at intervals for a period of time, he is using credit for the satisfaction of personal needs. Charge accounts represent consumption credit of this type.

Credit Has Many Advantages.—What are some of the advantages of using credit in purchasing commodities and services? Here are a few.

Credit Makes Possible Greater Production and Easier Exchange of Goods.— Because it is possible through credit arrangements for manufacturers to obtain large quantities of raw materials, machinery, tools, and laborers, they can produce goods in large quantities in anticipation of demands. Without credit facilities it is doubtful if large-scale production could continue to be carried on. Likewise, credit makes it possible to exchange goods that have been produced. This is accomplished through the extension of time for payment of the goods. Without credit this could not be done; cash would be required, thus slowing down exchange of goods.

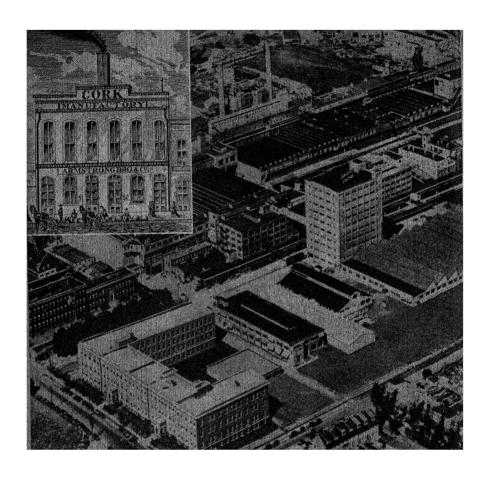
Credit Makes It Easier to Make Distant Payments.—It frequently happens that goods are bought from a distant producer or that an individual has occasion to make a payment to someone in another city. It might not be safe to send large sums of money through the mails. Of course, a money order could be obtained, but this is expensive and often is not convenient. By means of checks or drafts, any quantity of money can be sent anywhere with safety and ease.

Credit Makes It Possible for Individuals to Enjoy Many High-priced Articles While Paying for Them.—Because of credit few people now wait until they have the cash before buying something that will add to their comfort or advancement. The salesman needs an automobile but seldom is able to pay cash for it. Credit enables him to have it while paying for it. This is also true of many articles which save labor in the home and which add to the happiness of the family. Thus credit makes it possible for us to have many things that would otherwise be difficult to obtain promptly.

Credit Makes It Possible for Large Corporations to Exist.—We live in an age of big business, with corporations the prevailing form. Corporations are possible because they are able to obtain large sums of money through the sale of bonds and stocks. A business that had to depend upon cash entirely for its operation and expansion would be rather small.

Credit Makes It Possible for Governments to Perform Their Functions.—Corporations and individuals are not the only ones that are able to carry on because of credit. The various forms of government would find it impossible to function efficiently if they had to depend wholly upon the cash they could obtain from taxes. They have to borrow much of their money. Credit enables governments to perform many services that people demand and to anticipate future public needs.

Credit May Cause Trouble.—Like everything else credit has its good points and its bad points. Experience has shown that the abuse



Courtesy of Armstrong Cork Company

CREDIT MADE THIS POSSIBLE—Starting with a one-room factory in Pittsburgh, Thomas Armstrong and his brothers (partners) operated a small factory, shown in the inset, until 1873. Then they built a larger factory. In 1891 the Armstrong Cork Company incorporated. Today this company has many factories, largest of which is the 60-acre plant of the Floor Division at Lancaster, Pennsylvania, which is shown in the photograph.

of credit has caused harm to individuals and to business in general. Let us examine some of these dangers.

Credit Often Leads to Extravagance and Debt.—It is so easy to obtain goods now for a mere "charge it" or for a relatively small first payment and "easy payments" spread over a period of time, that many are induced to buy more than they should or things that they cannot afford. Such arrangements mean being in debt for a long time; they also mortgage future income.

Credit Causes Prices to Fluctuate.—An increase in the use of credit has the same effect as an increase in the supply of money. This, you have learned, causes prices to rise. On the other hand, a decrease in the use of credit causes prices to decline. In either case someone is harmed. A great expansion of credit may be followed by a sudden collapse of credit.

Credit May Cause Business to Be Overexpanded.—When business is on the gain, businessmen wish to make all the profit they can. In their eagerness for increased profits they borrow from banks to increase the size of their business, to increase output, or to employ more workers. This is all very well so long as they are able to sell their goods at a profit. But, when many other businessmen do the same things, competition becomes keener and profits may become less or even disappear. This forces some out of business, with disastrous results for the owners, the banks, and the workers.

How Many Kinds of Credit Are There?—Credit exists in many forms in our business world. It is not necessary to explain in detail all these kinds of credit, but we shall explain briefly some of the commoner forms which you may have occasion to use some day. These are commercial credit, public or governmental credit, investment credit, agricultural credit, and personal credit.

Commercial Credit.—This is one of the commonest forms of credit in use today. It is the kind of credit that is extended by one businessman to another in the process of exchanging and marketing goods. The manufacturer ordinarily sells to the wholesaler or jobber on credit. The wholesaler sells to the retailer on credit. Very few business concerns have the necessary surplus funds with which to carry on their business at all times by means of cash. They make use of commercial credit, which is extended usually for a relatively short period of time, such as thirty, sixty, ninety days, or six months.

Public or Governmental Credit.—This kind of credit is represented by the borrowings of governments—local, state, and national. It arises from the sale of short-term notes, or the issue of paper money by the national government. The ability of governments to borrow is based upon the faith people have in the stability of their government, plus its ability and willingness to repay the money borrowed. You have heard of United States notes, municipal bonds, and United States War bonds.

Corporation or Investment Credit.—This kind of credit is represented by corporation bonds and notes, which are written promises to repay borrowed money. Corporation credit is used to obtain funds needed for permanent capital and thus is long-term credit. The ability to borrow money in this way depends upon the general credit of the firm issuing the bond. It is a very common form of credit in the United States. You are all familiar with the bonds issued by public utilities, railroads, and industrial corporations.

Agricultural Credit.—This is the kind of credit needed by those who are engaged in agricultural pursuits because of the peculiar nature of their occupation. After crops are planted, several months must pass before the farmer can harvest them and obtain money. In the case of those who breed livestock, a longer time than usual is required before any cash can be obtained for the product. Credit is needed for periods varying from nine months to a year or more. Agricultural credit is based upon mortgages on farm property or on promissory notes running for several years.

Personal Credit.—Most of the forms of credit just described are used by corporations or governments for purposes of industrial production or public service. Personal credit is used by individuals for purposes of satisfying personal needs. Whenever an individual buys commodities or services and promises to pay for them later, he is using personal credit.

Personal credit is probably the commonest form of credit; it is used by all groups of people, for all sorts of commodities and services. It is dependent upon certain factors, the most important of which is character. Ability and willingness to pay are important too but not to the same extent as in commercial or corporation credit.

How Is Personal Credit Used?—Personal or consumer credit exists in two forms: charge accounts and installment buying.

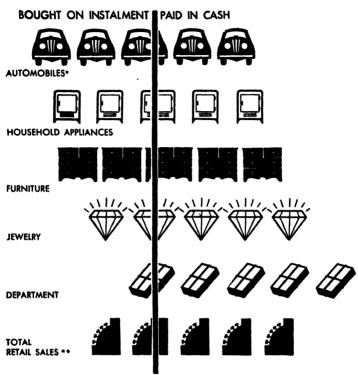
Charge Account.—It is said that about half the retail and wholesale business of the United States is conducted on a charge-account basis. This is a form of credit whereby a consumer may purchase any kind of goods with the understanding that he will pay for it at the end of a stipulated period in one lump sum. This period is now within forty days after the bill has been rendered.

The charge account has several advantages for the consumer: (1) It enables him to enjoy the use of the goods before he is required to pay for them. This is especially convenient at such times as Easter and Christmas. (2) He may pay for purchases made from time to time throughout the month in one lump sum soon after the end of the month. This is convenient for those whose salaries are paid monthly and whose families need certain articles during the month. (3) Those who maintain charge accounts may be given the opportunity to select goods offered in a special sale before the general public is notified. This enables them to make a better selection and perhaps to get better value for their money.

But charge accounts can be a disadvantage to consumers if they do not make a wise use of them: (1) It is so easy to have articles charged without having the money with which to pay that many are tempted to purchase more than they need and even to buy unnecessary articles. This means that the money cannot be used for essential purposes. (2) Charge customers frequently abuse the privilege of returning goods that are unsatisfactory. This leads them to order articles which they have not seen or which they are not sure they want. Stores lose money through this practice although they do not feel that they can refuse the privilege. Consumers must pay the costs which their abuse entails.

Installment Buying.—This method is used when buying articles that are expensive and usually quite durable. These articles are often speken of as luxuries although many of them have become necessities to thousands of people. When installment buying flourished, it was possible to purchase goods by making a small down payment and stretching the payment of the balance over a long period of time, in some cases as much as three years. But in 1942 it became necessary to prohibit the manufacture of many of the articles formerly sold on the installment plan and to restrict greatly the terms of purchase of those articles which could still be bought. At the present time, when buying such articles as washing machines, refrigerators, radios, household furniture, and electrical appliances, the buyer must make a first payment of at least 20 per cent of the purchase price and complete payments in not more than twelve months. In the case of automobiles, one-third of the purchase price must be paid in cash and the balance in not more than fifteen months. The buyer is required to sign certain legal papers and agree to make his payments at definite times and in most cases to pay interest on balances still due. The seller retains the ownership of the article until the final payment is made and may

# HOW MUCH IS BOUGHT ON THE INSTALMENT PLAN 1940?



Each symbol represents 20 per cent of total retail sales

\*National Automobile Dealers Association \*\*

\*\*Estimate of the National Retail Dry Goods Association

SOURCE: National Bureau of Economic Research: Duncan McC. Holthausen, "The Volume of Consumer Instalment Credit, 1929-1938"

Department of Commerce

#### PICTOGRAPH CORPORATION, FOR PUBLIC AFFAIRS COMMITTEE, INC.

INSTALLMENT CREDIT—Installment credit is a form of personal credit. It enables consumers to buy fur coats, among other articles, on reasonably easy terms. Could these furs be bought today on the terms advertised here?

take back the article through repossession if the buyer fails to make a payment when due.

If wisely used this method has certain advantages: (1) The consumer has the use of the article at once and enjoys its use while paying for it. This is a distinct advantage to many people. Those whose incomes are small would find it difficult, if not impossible, to save enough money with which to purchase some needed household

equipment. For example, it would take a long time to save enough money to buy an oil heater for the home. The installment plan enables the consumer to have such household equipment at once and to pay for it out of earnings. (2) This plan makes it possible for those on small incomes to enjoy a few luxuries. Homes can be equipped with many laborsaving devices, alterations for the convenience of the family can be made, and better clothes can be bought. (3) It may even develop habits of thrift and saving. Careful planning of the income must be followed in order to meet the monthly payments. This practice continued over a year or more develops the habit of saving, which can be continued after the payments are all made.

But, like everything else, installment buying has been abused. Certain disadvantages have come to light: (1) The consumer may be induced to buy more than he can afford and so plunge himself into serious debt. Because dealers are anxious to sell their goods and know that they are protected when they sell on this plan, they frequently bring pressure to bear upon buyers to purchase their goods by stressing the ease with which payments can be made. This pressure is hard to resist. (2) Few consumers stop to figure out the real cost of the



Keystone View Co.

INSTALLMENT PLAN Installment buying is often used in purchasing expensive and durable articles, such as automobiles and fur coats. Here is advertised an easy-payment plan for purchasing clothes.

article they buy in this way. When a person buys a dining room suite for \$250 and gives \$50 as the first payment, someone must advance the remaining amount. This is usually a finance company which must be paid for the use of its money. In addition, charges are added for credit investigation, insurance, bookkeeping, collections, and the possibility of repossession. These are called "carrying" or "service" charges; they sometimes amount to a considerable sum.

Several Instruments Are Used in Credit Transactions.—Along with the growth of credit there have developed several credit instruments, which will now be described.

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Carpety - six read -	100 DOLLARS
The state of the s	Correspond

A CHECK—John P. Sensa has money in a checking account in the Union Trust Company. He makes out a check to William R. King for \$86.40. Mr. King may cash this check at any bank by endorsing it, provided he is known at the bank or is identified. He may cash it at other places also, such as stores, or he may transfer it to some other person or company.

Springfield, Mass, <u>December 16 10 45</u> Thirty days	8,
TO THE ORDER OF Samuel L. Hopkins  One thousand three hundred six $100$ DOLLARS	DIST
AT THE SPRINGFIELD SAFE DEPOSIT AND TRUST COMPANY  family C. See	DUE
	NUMBER

A PROMISSORY NOTE—Wherein does the giving of such a note for goods purchased differ from payment by check?

Check.—A check is a written order by a depositor, directing his bank to pay money to a third party. A check may be made out to cash, to bearer, or to a third party. It is used by the depositor to pay bills locally or in other parts of the country. It may also be used by the depositor to draw money out of the bank for personal use.

In everyday business transactions the check is more commonly used than money, chiefly because of its convenience. A check may be drawn for any sum the depositor has in the bank; it can be sent safely through the mails; payment on it can be stopped; and when canceled, it serves as a receipt for the payment made, provided its purpose has been written on the check. A check may also be passed on from person

<u>#_3000##</u>	Springfield, Mass. December 20, 19 45
xxxxxxxxxxxxxxxxx At	sight xxxxxxxxxxxxxxxxxxxxxx Pay to
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,	d xxxxxxxxxxxxxxxxxxxxxxxxxxxxxx Dollars
Bill of Lading, Insuran	nce and other papers attached
Value received and charg	
To Anderson and Johnson	)
No. 15 State St., Boston	Mass. Winslow and Jones

A BILL OF EXCHANGE—Is this a domestic or a foreign bill of exchange?

ш -/	<u>, 203</u>	Springfield, Mass. December 12 19 45
Z J	Anderson & Johnson	15 State St., Boston, Mass.
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A TRADE ACCEPTANCE—Note how this differs from the bill of exchange.

to person through indorsement, that is, by writing on the back the name of the person receiving the check.

Promissory Note.—A promissory note is an unconditional written promise given by the maker to pay a certain sum of money to another person on demand or at a fixed or determinable time. These notes may be given by individuals, partners, corporations, banks, and governments. They may be backed by a definite pledge of something of value or merely by the word of the maker. Like checks, promissory notes may be endorsed and passed from one person to another. The one who endorses a note assumes liability for its payment if the maker fails to pay.

Bill of Exchange, or Draft.—A bill of exchange is an unconditional order in writing addressed by one person to another, requiring the person to whom it is addressed to pay on demand or at a fixed future time, a certain sum of money to the order of a named person or to bearer. Bills of exchange are of two

kinds: (1) domestic bills, which are bills payable within the country, and (2) foreign bills, which are payable in a foreign country. The person who draws the draft is called the *drawer*; the person on whom it is drawn is called the *drawee*. Drafts are also called *sight drafts* and *time drafts*. Sight drafts are payable when presented; time drafts are payable on the date named in the draft.

Trade Acceptance.—A trade acceptance is a time draft, drawn by the seller of goods on the buyer for the purchase price and accepted by the buyer. The buyer usually accepts by writing or stamping the word "accepted" across the face of the draft, indicating the place and the time of payment, and signing his name. Most trade acceptances now have the necessary form printed on them. Trade acceptances have not been used as generally in the United States as they have been in Europe.

**Summary.**—The credit system was developed to make exchanges of commodities and services more convenient and rapid than the money system provided. It is used along with the money system but to a much greater extent. It is based upon confidence, character, and ability to pay.

Credit is used for two primary purposes: for uses in production and for the satisfaction of personal needs. Credit has many advantages and some disadvantages. Chief among the advantages are that it makes possible greater production, makes it easier to exchange goods, makes it easier and safer to send payments to a distance, affords individuals an opportunity to enjoy many high-priced articles while paying for them, makes it possible for large corporations to exist, and enables governments to carry on their functions.

Among the disadvantages may be listed the following: it often leads to extravagance and debt, it causes prices to fluctuate, and often results in an overexpansion of industry.

The business world is familiar with several kinds of credit. The forms that are best known are commercial credit, corporation credit, public or governmental credit, agricultural credit, and personal credit. Each of these forms of credit has given rise to one or more instruments of credit. The most commonly used of these instruments are the check, the promissory note, the draft or bill of exchange, and the trade acceptance. All these credit instruments may be passed from person to person by endorsement. They have been most useful in speeding up exchanges and in adding to the safety and convenience of transferring funds.

## Questions to Test Your Knowledge

- 1. Define credit. Upon what foundations does it rest?
- 2. State the two purposes of credit with an example of each.
- 3. List the advantages and disadvantages of credit.
- 4. Name the five kinds of credit.
- 5. Define and give an example of the use of commercial credit.
- 6. How does corporation credit differ from governmental credit?
- 7. Why is agricultural credit different from other forms of credit?
- 8. Define personal credit. What two forms does it take?
- 9. How does the charge account differ from installment buying?
- 10. Name the four commonly used credit instruments.
- 11. What is a check? State the advantages in using checks.
- 12. How do drafts differ from checks?

## Questions for Discussion and Application

- 1. What does the word credit mean in each of the following phrases: (a) "Positively no credit"; (b) "Radios on credit"; (c) "He has an excellent credit rating"; (d) Credit Bureau; (e) "She has ten credits toward a diploma"?
- 2. "If you need it and can't pay cash for it, get it on credit." Is this always good advice? Discuss.
- 3. Is a person justified in buying things he cannot afford to pay for when he buys? If not, how would the automobile industry be affected?
- 4. In case a banker is considering extending credit to a businessman, which would he consider of greater importance—the moral character of the borrower or the condition of his business? Would the case be any different if the borrower were a corporation?
- 5. It has been claimed that credit causes prices to fluctuate, thereby bringing hardship to those on small incomes. Explain how credit may cause changes in price levels.
- 6. List as many economic and social advantages of installment buying as you can. Why do you consider these advantages?
- 7. "The greater use of credit in recent times has made business fluctuations more frequent and more violent." To what extent is this statement justified?

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## Floor Talks and Written Reports

- 1. Justifiable uses of personal credit.
- 2. Business without credit.
- 3. Government control of credit.

## Topic for Debate

RESOLVED, That installment credit should be confined to the purchase of necessities

## For Further Information

Babson, R. W., "The Folly of Installment Buying."

Kickhofer, W. H., "Economic Principles, Problems and Policies," pp. 294–305.

Nugent, Rolf, "Consumer Credit Dynamics."

Owens, D. F., "Controlling Your Personal Finances," Chap. XII.

Public Affairs Pamphlets, "Credit for Consumers," No. 5 (revised); "How Money Works," No. 45.

Smith, A. H., "Your Personal Economics," Chaps. 5, 6, 7.

#### PROBLEM 18

## Installment Buying

There is a difference of opinion regarding the purchase of articles that are high priced and relatively durable. Some people prefer to leave their money in the savings bank at interest until they have enough for the purchase of the desired article. Others prefer to buy the article on the installment plan. The installment plan requires a higher rate of interest than is paid by the bank, but the buyer has the use of the article while he is paying for it.

Others claim that installment buying mortgages future income to too great an extent and leaves one without sufficient ready funds if an emergency arises. It is also urged that installment buying leads many to purchase goods out of all proportion to their income. This means being in debt for a long time and going without new and necessary goods in the meantime.

There seem to be two questions concerning installment buying: (1) Does it represent a reasonable program of expenditures based upon the chance that the income may be reduced or cut off by unemployment? (2) What about the relative utility of articles purchased on this plan?

1. The old New England idea of thrift was, never to buy an article until you have the money to pay for it. Has this idea become old-fashioned and

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unpopular? Have conditions changed to such an extent that this policy might be unthrifty and uneconomical?

- 2. Are there any advantages in paying cash for articles usually purchased on the installment plan? If so, name some.
- 3. Are we likely to lose sight of utility in buying on this plan?
- 4. State the advantages and disadvantages of buying on the installment plan.
- 5. Give your personal opinion of the installment-buying plan.

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# Chapter XV

# Banks and Their Services

#### Aims of This Chapter:

To learn how banks originated.

To examine the kinds of banks in the United States.

To learn what services banks perform.

To interpret bank statements.

You have learned that both money and credit are essential to the modern exchange system. You have also learned that the use of credit has increased greatly since it was introduced. But it would not be possible to transact business on a credit basis today if there were no institutions to create and control the use of credit. These institutions are called "banks." In this chapter we shall discuss the kinds of banks and the services they perform in the carrying on of exchanges of goods.

What Is a Bank?—The origin of banks is shrouded in mystery. No one knows for certain how or when they came into being. Some think they date back to the time when money-changers carried on their business on benches around the temples and churches. They exchanged the money of one region into the money of another region, charging a fee for this service. Thus one of the early ideas of a bank was a place where money changes took place. Others derive the term from an Italian word "banco" which means a "heap" or accumulation of money.

There are other ideas about the origin of the word. But no matter which idea is correct, we know that the term is used rather generally to designate almost any institution which is concerned with the receiving of money and making of loans, or which aids exchange in any way. It may be defined as follows: A bank is an institution that creates credit and makes exchanges possible.

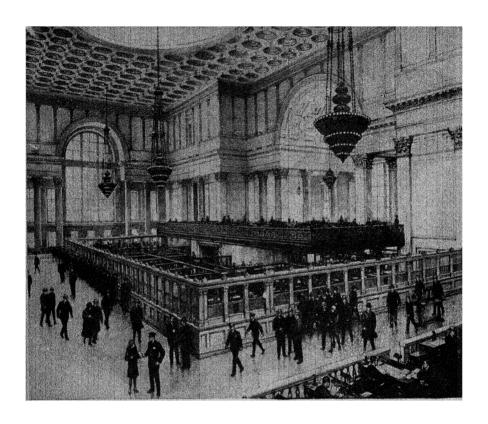
How Does a Bank Create Credit?—It is not difficult to see that banks furnish the machinery for the conduct of business transactions mainly through the use of the various credit instruments and the services which will be described later. But it may not be quite clear how a bank creates credit. We shall try to make this clear by an explanation.

Very early in the history of banking it was discovered that many people deposited sums of money which they did not withdraw for long periods of time. In fact, there was always a large sum of money in the hands of the bankers that was not called for. This being so, bankers began to lend some of this money to those who needed it. So long as they kept on hand an amount sufficient to take care of the needs of depositors from day to day, they found they could lend the balance safely. Thus a bank with deposits of \$500,000 could safely lend \$400,000 of this amount. Since those who borrowed the funds did not want the actual money but were satisfied with a credit on the books of the bank against which they could draw, the deposits of the bank increased every time a loan was made. This made it possible for the banks to make more loans. In this way the banks create credit.

This will be clearer if we give a definite example. Suppose a local merchant finds that he needs \$1,000 for immediate use in his business. He goes to his bank and, after he has given the proper security, the bank agrees to lend him the money. The merchant signs a note agreeing to repay the loan with interest at the end of a certain time. Since the merchant is a depositor of this bank, the bank merely credits his account with \$1,000. The merchant has received no money but he has been given the right to draw checks against the \$1,000. In other words, he has been granted credit that did not exist before. The bank is now able to lend about \$800 more because of this new deposit of \$1,000 and is able to create more credit.

There Are Several Kinds of Banks.—There are many ways of classifying banks. There are state banks, national banks, and Federal Reserve banks as well as private banks. But our interest is in the classification according to the services they perform. We shall consider commercial banks, savings banks, trust companies, and cooperative banks.

Commercial Banks.—This is the type of bank with which businessmen are most concerned. It is also the type that many persons use



Courtesy of National City Bank of New York

A COMMERCIAL BANK—This is the interior of one of the largest commercial banks in the world. Note the desks of the officers in the foreground and the guards at various points on the floor. These guards serve both as protectors of the bank and as information personnel for the customers.

who wish to pay their bills by means of checks. It deals primarily with the day-by-day needs of business. Its chief business is to provide borrowers with the funds needed for a month, or a few months; that is, with temporary working capital.

A commercial bank is supposed to keep its funds in as liquid a state as possible so that it may be ready at any time to meet the demands of its customers. It receives deposits from businessmen and others and pays out this money when depositors demand it. These demands are made through checks.

Savings Banks.—This is probably the first kind of bank with which you will have dealings. Its fundamental purpose is to encourage thrift. It provides a safe place to keep your savings and invests these savings for your benefit. The deposits are invested in first-mortgage bonds, government bonds of all kinds, and other high-grade securi-

ties. From the proceeds of these investments the bank pays interest to the depositors at regular intervals.

The savings bank is intended to serve the workingman or the man who can save only in small amounts. It is not intended for the businessman or the rich man. It limits the amount any one person may deposit for the purpose of drawing interest. This amount varies in the different states from \$4,000 to \$5,000. An account may be opened with as little as \$1 and deposits of \$1 or more may be made as often as one wishes. Savings banks are chartered by the state; they are restricted by law in the investment of their funds. If you wish to withdraw money at any time, you will have



Acme Photo

THE SAVING HABIT—The elderly gentleman shown above made his first deposit of \$3.10 in this savings bank when it opened in 1855. Each year since then he deposited the same amount on the same date. He was nine years old when he began to save. He made his eighty-fourth deposit in 1939. How much had he deposited in 1939?

no difficulty although the banks may require thirty days' notice.

Savings banks are of two kinds: stock and mutual. The *stock savings* bank has capital and stockholders. After this type of bank has paid all its expenses, paid a fair return to the depositors, and set aside a reserve, the balance is paid to the stockholders in the form of dividends.

The mutual savings bank has no capital and no stockholders. It is organized for the benefit of the depositors, who are the owners. After the expenses of operation and an amount for reserve have been deducted, all the profits are supposed to go to the depositors. It is customary to set aside a surplus before paying the depositors. Mutual savings banks are common in New England and some of the other Eastern states.

Trust Companies.—These are state-chartered banks which received their name from the special functions they performed when they were first organized. In the beginning these banks acted as trustees, executors, and administrators of estates, guardians to minors, and as custodians of funds held in trust. As time passed, the trust company

has gradually assumed other functions, until now it performs all the functions of commercial banks and savings banks in addition to its trust functions.

Trust companies lend money on short terms to businessmen and on long terms to others. They thus supply both temporary and permanent capital. They act as treasurers for churches, community chests, and charitable institutions; they aid corporations by acting as registrars and transfer agents for stocks and bonds; they even conduct the complete affairs of a business in the capacity of receivers. Thus trust companies are commercial banks. They differ from national banks in that their charter comes from the state while the charter of a national bank comes from the Federal government. Since national banks now perform all the trust functions of state banks, it makes little difference which one you use.

Cooperative Banks.—In some sections of the country these are called "building and loan associations." They were originally organized by a mutual group for the purpose of obtaining money for the building of homes. They still perform this function but have added the function of investment with no idea of borrowing for a home.

There is a variation in the plan of operation of this type of bank throughout the country. The ownership of the bank consists of shares, which are usually bought on the installment plan. The shares may be paid for at the rate of \$1 a month for a period of about 13 years, each share maturing at \$200. Sometimes the number of shares that any one person may own in one bank is limited. The bank invests its funds in first mortgages on real estate and pays the shareholders a modest dividend. A depositor or shareholder may withdraw his money at any time after the first year, or he may borrow up to 90 per cent of the value of his shares by leaving his book as security.

These banks do not employ highly paid officials and their overhead is low. They are chartered by the state and are subject to the same regulations as savings banks. They are inspected by the state banking examiners at regular intervals and their deposits are insured to an amount up to \$5,000 either through the Federal Deposit Insurance Corporation (FDIC) or through an insurance fund contributed by the banks themselves.

Other Kinds of Banks.—The types of banks just described are the ones which the average individual is most likely to use some day.

There are other types which need some explanation, as they are used by many groups of people.

Postal Savings System.—This is an agency of the United States government which, through the Post Office Department, receives savings deposits, invests these deposits in government bonds, and pays the depositor 2 per cent interest. The system was started in 1911. It was used chiefly by foreigners who were suspicious of banks. Today any person ten years of age or over may open an account. Deposits may be made in as small amounts as \$1. These deposits are made in certain designated post offices, which give receipts for the amounts deposited. No more than \$2,500 may be deposited by one person.

Federal Farm Loan Banks.—These are chartered by the Federal government for the purpose of extending credit to farmers and others engaged in agriculture. The money is lent on first mortgages on farm lands in amounts of \$100 to \$25,000 for certain approved purposes. Loans are made through local farm loan associations or bank agents approved by the Federal Farm Loan Board.

Morris Plan System.—These are not actual banks but organizations for lending money to wage carners and others. The system was established in 1910 to make it possible for the small wage earner to borrow small sums of money without being obliged to resort to loan sharks or to pay too high a rate of interest. The prospective borrower goes to a Morris Plan office, where he makes his wants known. His character and earning power are investigated. If these are found satisfactory, the borrower then applies for a loan on a special form which has attached to it notes which must be signed by coendorsers.

This means that the borrower must get the signatures of two responsible persons who agree to pay the loan if the borrower fails to do so. The loan may run for a year or less. The cashier first deducts the interest and usually a dollar or more for an investigation fee. Thus, a person wishing to borrow \$100 actually receives only \$92. The borrower then repays the loan at a stipulated weekly rate. This system has been successful in promoting thrift among borrowers, who are, for the most part, industrious and honest wage earners or professional people.

What Jobs Do Banks Perform?—Not all the banks we have described perform the same functions. Some of them have special functions peculiar to the type of business the bank does. But there are

some functions that are common to all of them. For example, all banks receive deposits and practically all banks make loans and discounts. Some banks do not allow the checking privilege. Only Federal Reserve banks now issue notes although the national banks did so up to 1935.

Let us describe the functions common to commercial banks.

They Receive Deposits.—This is an important function of commercial banks. It consists in receiving from depositors sums of money against which the depositors may draw checks to make payments. Anyone may make deposits in a bank after he has opened an account. In accepting these deposits, the bank assumes the obligation to pay back the money in full or in part as the depositor wishes.

These deposits are of two kinds: demand and time. Demand deposits are those which may be withdrawn at any time on demand of the depositor. They are usually checking accounts. Time deposits are those which are left with the bank for a fairly long period of time. Savings deposits are usually time deposits.

They Make Loans and Discounts.—The chief source of income for banks comes from making loans and discounts. You should learn the difference between a loan and a discount. In the case of a loan, the bank gives the customer a sum of money and takes in return his promise to pay at a given time at a certain rate of interest. Let us assume that you have borrowed \$100 from a bank on a loan at 5 per cent. At the end of the year you return to the bank \$105. Thus, in the case of a loan, the customer receives and has the use of the full amount of money for the period. In the case of a discount, the bank deducts the interest at the start and gives the customer the balance; that is \$100 less \$5 or \$95. At the end of the period the customer pays back the face of the note, \$100. Thus, in the case of a discount, the customer receives less than the face of the note but pays back the full amount.

They Collect Checks.—This is a very important service, especially for businessmen who are receiving checks every day from all parts of the country. If a merchant receives a check drawn on a bank in a distant city, how will he get the cash? His problem is solved by his bank. He deposits the check in his local bank and the bank proceeds to collect the money. The local bank is a member of an association, called a "clearing house," which collects the money represented by the check. All checks drawn on banks outside the city are sent to the

bank is collected. New York City is collected. Mr. Brown in N.Y.C. receives Mr. Brown who has an account in from Mr. Smith a check drawn one bank in N.Y.C. receives from on a Philadelphia banked. Mr. Jones a check drawn on another bank in N.Y.C. Mr. Brown endorses check and Mr. Brown endorses check and deposits it in his N.Y.C. bank. deposits it in his own N.Y.C. bank. N.Y.C. bank sends check to Mr. Brown's N.Y.C. bank sends Federal Reserve bank of N.Y.C. check to N.Y.C. clearing house or N.Y.C. Federal Reserve bank. Federal Reserve bank of N.Y.C. N.Y.C. clearing house or Federal sends check to Federal Reserve Reserve bank sends check to Mr. Iones's N.Y.C. bank. bank of Philadelphia or to correspondent bank in Philadelphia. Federal Reserve bank of Phila-

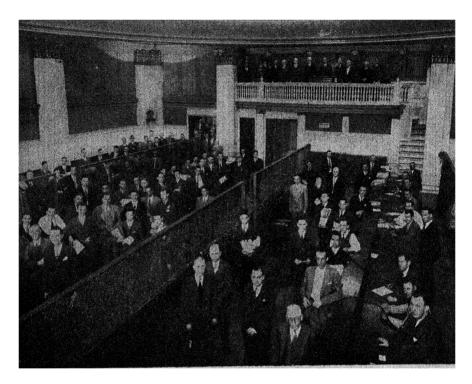
How a check received in New York

City and drawn on a different bank in

How a check received in New York

City and drawn on a Philadelphia, Pa.

delphia or correspondent bank of Philadelphia sends check to Mr. Smith's Philadelphia bank.



American Studio

CLEARING HOUSE. When there are many banks in a town or city, a clearing house facilitates the clearing of checks between the banks. Here clerks from local banks assemble each day and exchange their bundles of checks. The difference between the total amount of the checks drawn against a bank and the checks that it has paid for other banks is the amount which it owes the clearing house, or which, conversely, the clearing house must pay the bank.

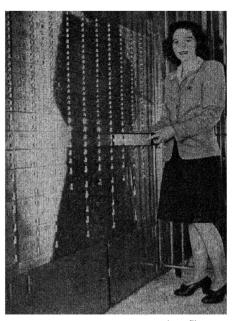
Federal Reserve bank of the district or to correspondent banks in other cities where they are collected.

They Insure Deposits.—The Banking Act of 1933 established the FDIC, whose purpose is to protect depositors against loss of their deposits in case the bank fails. The insurance funds come from three sources: (1) the United States Treasury, (2) contributions from the Federal Reserve banks, and (3) assessments levied on the insured banks. Only those banks which are members of the Federal Reserve System are protected by its provisions. The Banking Act of 1935 made the FDIC permanent and set the maximum deposit to be insured at \$5,000. Each insured bank displays a sign which states that its deposits are insured in the FDIC.

They Rent Safe-deposit Boxes.—In addition to receiving deposits of money and checks, many banks maintain safe-deposit boxes which

they rent to their customers. These boxes are for the safe keeping of jewelry, silverware, and such valuable papers as deeds, bonds, stock certificates, wills, and insurance policies. These safedeposit boxes are in vaults which are heavily protected and guarded day and night. If you ever have occasion to rent such a box, you will find that it takes two keys to open it. The bank officer in charge of the vault has a master key. which he inserts in the lock first. Then you use your key and the box opens. It cannot be opened without the two keys. The bank cannot open the box unless you are present. The bank does not know what is in your box, but it takes as good care of it as it does of its own valuables.

Federal Reserve Banks Issue Bank Notes.—There is one other function which formerly was per-



Acme Photo

SAFE-DEPOSIT BOXES—This is a safe-deposit vault of a large bank. Observe how the boxes range in size and that all are numbered. Note also that there are two locks to each box. The bank officer of the vault has a master key, which he inserts in one lock, and the renter of the box inserts his key in the other. It cannot be opened without the two keys.

formed by both national and Federal Reserve banks. This is the *issue of bank notes*, which circulate as money. In 1935 the national banks ceased to issue notes so that now bank notes are issued only by the Federal Reserve banks.

Bank Reserve.—The law requires that each national bank must set aside as a reserve a certain percentage of its deposits. This legal reserve against time and demand deposits differs for each; the amount required to be kept is governed by the size of the city in which the bank is located. In the case of state banks the legal reserves vary according to the banking laws and policies of each state. If the state bank belongs to the Federal Reserve System, it is required to maintain the same reserve as national banks.

Banks that are members of the Federal Reserve System are now required to maintain all their reserves in the form of deposits with the district reserve bank. In addition to this legal reserve, banks keep on hand an amount of cash sufficient to meet the everyday needs of their customers. This is called *cash on hand*.

What Is a Bank Statement?—All banks are required by law to publish from time to time a financial statement of their condition. These statements are published in the daily papers and are intended to show the public the true condition of the bank at that time. As many people do not understand these statements, a few words of explanation are in order.

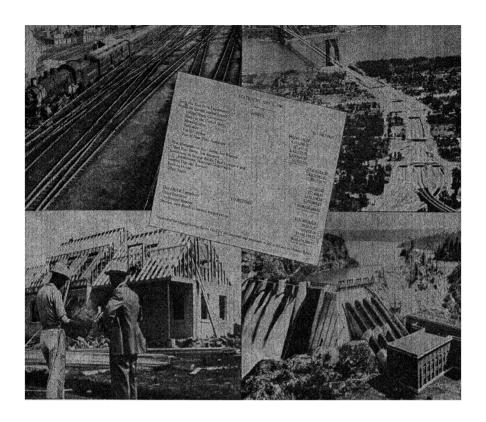
The bank statement is arranged in two columns: one column lists the resources of the bank, or what it owns; the other lists its liabilities, or what it owes. The two sides of the statement must balance. Some banks publish a detailed statement while others publish a simple statement. The accompanying bank statement is in condensed form but will serve to show the main items and what they mean.

STATEMENT	OF	CONDITION	
			т

RESOURCES		Liabilities	
Loans and discounts	\$1,500,000	Capital	\$1,000,000
Stocks and bonds	100,000	Surplus	100,000
Real estate	70,000	Undivided profits	20,000
Cash on hand	150,000	Deposits	740,000
Due from other banks	80,000	Due to other banks	40,000
	\$1,900,000		\$1,900,000

Explanation of Items in Statement.—Let us consider the resources first. It is to be expected that loans and discounts will be the largest item for, as has been explained, the bank's chief function is to lend money to those who need it for business purposes. Commercial banks invest some of their funds in bonds and stocks in order to earn profits in this way. Real estate represents the bank's ownership of its main office as well as any branches owned outright; it frequently includes real estate acquired by the bank because someone has defaulted on a loan. The meaning of cash on hand is obvious. It is the cash which the bank keeps on hand to meet the daily demands of customers. The item due from other banks refers to balances on deposit with correspondent banks including the balance with the Federal Reserve bank. These balances result from out-of-town checks which have been forwarded to the Federal Reserve bank or to correspondent banks for collection and credit.

The liability items need a little explanation. Capital is listed as a



Courtesy of Building America, Farm Security Administration, National Housing Administration, and Department of Interior

BANK STATEMENT—Shown above (center) is a bank statement. Under assets are listed money held in the bank vaults for everyday transactions; investments—Government bonds, railroad and public utilities bonds, and real estate; notes from individuals and corporations, and balances deposited in other banks. Under liabilities are listed the amount of money owed to the depositors of the bank; a "reserve" set aside for any possible loss, and a surplus which includes the amount paid into the bank by its stockholders.

liability because it is owed to the owners of the bank who have purchased its stock. Surplus is a liability because it is a part of the earnings that have been set aside by the directors for some purpose. Undivided profits are earnings that have not yet been paid to the stockholders. Deposits represent the actual money, checks, or notes entrusted to the bank by the depositors. They refer to both the time and demand deposits, which are often lumped in one sum in a condensed statement. The item due to other banks represents what the bank owes to other banks for various reasons but has not yet paid.

Summary.—A bank is an institution that creates credit and makes exchanges possible. A bank creates credit by lending sums propor-

tionate to its deposits. It can do this safely because the depositors seldom call for the entire sum that they have in the bank.

There are many kinds of banks in the United States. When classified according to functions, these are commercial banks, savings banks, trust companies, and cooperative banks. There are other types of banks which exist for special purposes. The Federal Farm Loan Banks extend credit to those engaged in agriculture. The units of the Morris Plan System, while not banks, make loans to wage earners and encourage thrift.

Banks perform several important functions. They receive sums of money for safe keeping and permit depositors to withdraw their funds by means of checks. They lend to individuals, firms, and corporations on good security. They discount notes. They also make it easy and convenient for merchants to collect payment on checks that they have received. They maintain safe-deposit vaults for safekeeping of important papers, and other articles of value. Finally, Federal Reserve banks issue their own promissory notes, which circulate as money. Banks also insure the deposits of their customers up to \$5,000.

Banks are required by law to maintain a legal reserve against their time and demand deposits. In addition, they keep on hand an amount of cash sufficient to meet everyday needs of their customers. National banks have their reserves set by Federal laws. In the case of state banks the legal reserves vary according to the banking laws of each state.

From time to time banks publish a statement of their financial condition so that the public may know just how sound the banks are. These statements are usually published in the local newspapers.

## Questions to Test Your Knowledge

- 1. How would you define a bank?
- 2. Explain how a bank creates credit.
- 3. Name the chief kinds of banks and explain their main functions.
- 4. How do trust companies differ from national banks?
- 5. Distinguish between stock and mutual savings banks.
- 6. How do cooperative banks operate? State their two purposes.
- 7. List the functions performed by banks.
- 8. Distinguish between loans and discounts. Illustrate by examples.
- 9. What is a bank reserve? Who determines the legal reserve of banks?

- 10. What is a bank statement?
- 11. How does the Morris Plan System operate?
- 12. What is the purpose of Federal Farm Loan banks?

## Questions for Discussion and Application

- 1. When you deposit checks in your bank and draw others in favor of your creditors, does the bank actually move money about? If all the parties interested dealt with the same bank, would that bank serve as a sort of clearing house for these individuals?
- 2. Compare the deposits of a commercial bank with the deposits of a savings bank as regards (a) their source, (b) their character, (c) the use to which they are put.
- 3. Banks are said to create money out of nothing. Discuss this statement.
- 4. Explain the ways in which demand deposits may be created.
- 5. Explain in detail why capital, surplus, and undivided profits are listed as liabilities instead of assets in a bank statement.
- 6. "An increase in a bank's loans and discounts usually is accompanied by an increase in its demand deposits." Discuss the truth or falsity of this statement.
- 7. Show that a well-managed cooperative bank is an excellent medium for the accumulation of funds for later years.

## Floor Talks and Written Reports

- 1. Responsibility of the banker to the public.
- 2. Cooperative banks and their advantages.
- 3. How a clearing house operates.

## Topic for Debate

RESOLVED, That all banking should be a government function.

## For Further Information

Brandeis, L. D., "Other People's Money."

Gemmill, P. F., "Fundamentals of Economics," pp. 192-200.

Holdsworth, J. T., "Money and Banking," Chaps. X, XIII, XIV, XVI, XVIII.

Kniffin, W. H., "How to Use Your Bank," Chaps. I-III.

Rufener, L. A., "Money and Banking," Chap. XIV.

Smith, A. H., "Your Personal Economics," Chaps. 20, 21.

#### PROBLEM 19

## Financial Statement of a Bank

In a small industrial community several public-spirited citizens felt that there was a need for more banking facilities than the one national bank supplied. Accordingly, they applied for a charter to operate a commercial bank and trust company. The charter was granted and the bank began operations. It was a success from the start. At the end of five years the bank shows the following:

Capital	\$ 500,000	Cash on hand	\$350,000
Deposits	1,200,000	Due from other banks	80,000
U.S. government bonds .	250,000	Undivided profits	20,000
Loans and discounts	850,000	Surplus	40,000
Real estate	100,000	Due to other banks	10,000
Other securities	140,000		

Rearrange these items in the form of a financial statement for publication in the local papers. Would you say that this bank was in a sound condition?

#### PROBLEM 20

#### The Consumer and the Bank

Mr. Brownell has a checking account at the local commercial bank because he often has to pay bills in distant cities. He has persuaded his wife that it is a good plan for her to establish an account in her name from which to pay certain household bills. They find that the convenience of the checking account more than makes up for its cost. At the end of the month they receive from the bank the canceled checks that have been paid that month, and these serve as receipts. They also find that maintaining a checking account helps them in their budgeting. The bank has a safe-deposit department where the family keep their war bonds, deed to the house, insurance policies, and other valuable papers. Their checking account is protected by the FDIC. The savings bank serves as a safe place to keep their emergency fund and pays them a small rate of interest. The Brownells find banks very convenient and safe places for their funds.

- 1. How does a commercial bank aid the housewife in paying bills?
- 2. What services do banks perform for consumers?
- 3. Why do banks make charges for drawing and cashing checks?
- 4. How does a checking account aid in budgeting?
- 5. For what purposes are savings banks used?
- 6. Look up the provisions of the FDIC.

# Chapter XVI

# Banking Systems of the United States

## Aims of This Chapter:

To learn why the national banking system was established.

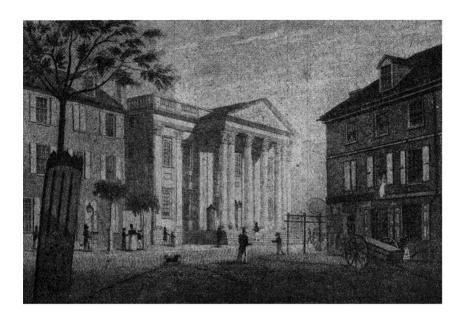
To discuss the defects of the national banking system.

To study the organization and functions of the Federal Reserve system.

To examine the latest developments in our banking situation.

The present banking system of the United States with its thousands of institutions which provide for the financial needs of the country is the outgrowth of many years of banking experience here and abroad. This chapter will explain the efforts made to develop an efficient system of banks and the difficulties encountered in the struggle.

First Bank of the United States.—By 1783 there were probably only a few well-established institutions which could be considered banks. These were practically all under the supervision of the colonies. When the government under the Constitution was inaugurated, an immediate need was felt for an institution that could act as the financial agent of the government and serve as a place for the safe keeping of its funds. Such a bank was set up in 1791 on the recommendation of Alexander Hamilton, our first Secretary of the Treasury. The government owned 20 per cent of the stock of this bank, which was called the First Bank of the United States. In addition to acting as the financial agent of the government, it could issue its own notes, establish branches for discount and deposit only, and could lend on mortgages. The bank was a success from the start and did much to stabilize the currency and to prevent the overissue of notes by other banks.



Culver Service

THE FIRST BANK OF THE UNITED STATES—The forerunner of all bank buildings in America, the Girard Bank was built in 1797 as the First Bank of the United States. Because it became too influential, a new charter was refused in 1811, and it was then converted into a private bank. The building still stands in Philadelphia.

Because the new bank competed with the state banks and exercised certain regulatory powers over them, it became an object of criticism and jealousy. It was claimed that many of its stockholders were foreigners and that the larger part of the profits were going to England to finance a war against us. There was some truth in these charges, but the most serious objection was that the bank was becoming too powerful and was influencing the government. As a result the bank was refused a new charter and expired in 1811.

Second Bank of the United States.—Not long after this the War of 1812 began. Just when a strong bank was needed to aid the government in financing the war, it was abolished. The government was forced to place its funds in the state banks. But these state banks were weak and undependable. Many of them failed and cost the government much money and great inconvenience. No doubt it cost us more to finance the war than would have been necessary had there been a strong national bank.

Congress became convinced of the need for a new bank and chartered the Second Bank of the United States in 1816. This bank

was similar to the first, and the government also owned 20 per cent of its stock. It became a powerful institution, whose notes were accepted all over the country. But, like the first bank, it incurred the ill will of the state banks and was accused of being too powerful and influential in government circles. President Andrew Jackson was unfriendly to it because he thought it had contributed funds to help defeat him. When the bank asked for a renewal of its charter, Congress approved but Jackson vetoed the bill. Accordingly, although very successful, the bank ceased to function as a national bank in 1836. It tried to carry on under a Pennsylvania charter but was unable to survive the panic of 1837.

Independent Treasury System.—After he vetoed the charter of the second bank, Jackson withdrew all government funds from the bank and deposited them in a few selected state banks. Because these banks were favored by the government, they were called "pet banks." Many of them were unable to survive the panic of 1837, and the government lost much of the money deposited with them. Government officials then did not know what to do with government funds, since there was no national bank and the state banks were unsafe. After much debate, Congress passed the Sub-Treasury Act which established the Independent Treasury System.

This was another experiment that was to prove wasteful and costly. The Federal government was required to keep its funds in treasury vaults in Washington and in various subtreasuries located in the most important commercial centers throughout the country. These subtreasuries received payments made to the government and paid out money for the government. But there were many disadvantages in the plan. For one thing, the money stored in the vaults was withdrawn from circulation and thus was of no use in business. Moreover, it earned no interest. Whenever it became necessary to ship money from one part of the country to another, there was an added expense and the danger of theft or loss. In 1921 all the subtreasuries were abolished, and their functions were transferred to the Federal Reserve banks.

State Banks.—As has been stated, the state banks were weak and undependable, and many of them failed in 1837. However, until 1863 there existed only state banks and private banks to carry on the financial affairs of business. Each state developed a banking system of its own with its own requirements and regulations. Some of these

systems were sound and functioned well; but many of them were weak and were under loose control or virtually no control at all. Each bank issued its own notes, so that by 1861 it is said that there were more than 1,600 kinds of bank notes in circulation. This made for confusion, inefficiency, and counterfeiting.

National Banking System.—Before the Civil War began many prominent officials and businessmen urged a study of banking facilities and the establishment of a centralized system of banks' under government control. But not much progress was made until the war was two years old. The government was finding it very difficult to finance the war, and the currency was in a chaotic state. An agency for the sale of government bonds at less cost to the government was badly needed.

Accordingly, in 1863, Congress passed the National Bank Act, which was revised a year later. This act permitted the formation of a new system of banks called "national" banks. They were authorized to issue their own notes, which were to be secured by the purchase of government bonds. These bonds were deposited in the United States Treasury, together with a 5 per cent redemption fund. In this way the government set up a market for the sale of its bonds. In 1866, Congress placed a 10 per cent tax on the issue of all state bank notes, which had the effect of forcing them out of existence. Because the national bank notes were protected by government bonds and a redemption fund, they were safe. Moreover, they were issued by a government bureau to all banks in the same form and so were uniform.

The national banks were authorized to receive deposits, discount commercial paper, lend on proper security, issue circulating notes, and perform such duties as were necessary to carry on a banking business. They were limited as to the amount they could lend to one borrower and as to ownership of real estate. This system was a distinct improvement over anything that had existed up to this time. But it was not a centralized system, and there was no central authority to control the banks making up the system. This led to many difficulties.

Defects of the National Banking System.—Many defects developed but we shall discuss only the most serious of them.

Little Cooperation among the Banks.—Each national bank was an independent organization. It was organized as a corporation in a community that felt the need of a new bank. If it had the required amount of capital and met certain other features of the banking act, it could do business. It felt no great dependence upon any other banks.

When a serious situation threatened, each bank took measures to look out for itself, regardless of the effect on other banks. This proved serious in a period of stress.

Reserves Not Centralized.—The banks were required to keep part of their legal reserves in banks in other cities. The banks were divided into three classes according to the size of the city. There were central reserve cities, of which New York and Chicago were the most important; reserve cities, which were cities of over 100,000 inhabitants; and country banks, which included all others. Most of the reserves of the smaller city banks and the country banks found their way to the large banks of New York City. When unusual demands were made on a bank, it had difficulty in calling in its reserves in time to help. This gave rise to the belief that the system was a "panic breeder."

It worked something like this. When a bank in one city called for its reserves in another city bank, this bank in turn had to call for its reserves from the New York City banks. The New York banks had lent funds to brokers on demand loans. These loans had to be called in. This meant that stocks had to be sold in a hurry to raise the money; the result was, at times, a panic which greatly upset business.

Currency Was Inelastic.—Currency is inelastic when it cannot be expanded or contracted as business demands an increase or a decrease of the money in general circulation. The national bank notes were issued by purchasing government bonds and having the notes printed and sent to the banks. The entire process took several months. When business needed more money, it could not be obtained in time to be of much help. Likewise, when the need for extra money had passed, it was not easy to dispose of the bonds in order to retire the currency. Not only did the banks find it difficult to sell the bonds, but sometimes it meant selling at a loss. Thus national bank notes were inelastic.

Federal Reserve System.—Because of the defects of the national bank system just described and because of the situation which resulted from the panic of 1907, a new banking system was established. This is known as the Federal Reserve System, which was set up in 1913.

The country was divided into twelve districts, known as Federal Reserve districts, in each of which a Federal Reserve bank was located. Thus, instead of one central bank as many people had desired, we have twelve district or regional banks. Each of these twelve district banks is a separate and distinct organization, managed by a board of directors and owned by the member banks of the dis-



The twelve Federal Reserve Districts.

trict. A Federal Reserve bank is a bank for bankers only. It does business with the member banks and with the government. A member bank is a commercial bank, with which every businessman is familiar.

These twelve banks are tied together through the authority and supervision of the Board of Governors of the Federal Reserve System. All national banks *must* join the system. State banks, mutual savings banks, and Morris Plan banks *may* join under certain conditions. Each member bank must subscribe to an amount of capital stock of the Federal Reserve bank equal to 6 per cent of its own paid-up capital and surplus. So far only 3 per cent has ever been called for.

How Is a District Reserve Bank Organized?—Each of the twelve district banks is managed by a board of nine directors, six of whom are chosen by the member banks of the district; the remaining three are appointed by the Board of Governors in Washington, D.C.

Generally speaking, the business of a district bank is managed by its board of directors just as is done in any commercial bank. The president of the district bank is the chief executive officer of the institution and corresponds to the chief executive or president of any commercial bank. He is appointed by the board of directors, with the approval of the Board of Governors in Washington, for a term of five years. All other executive officers and all employees of the bank are directly responsible to him.

Board of Governors of the Reserve System.—At the head of the Federal Reserve System is the Board of Governors. This Board exercises general supervisory powers, passes regulations for the proper functioning of the system, changes reserve requirements as needs arise, and keeps the entire banking machinery of the country running smoothly. It is composed of seven members who are appointed by the President of the United States with the approval of the Senate, for a term of fourteen years. They are not eligible for reelection. One of the members of the Board is designated as chairman and one as vicechairman, to serve as such for a term of four years. The Chairman of the Board is its executive officer.

In making these appointments, the President must see that the various sections and interests of the country are represented. No two members may come from the same district. The members of the Board receive a salary of \$15,000 each and are expected to devote all their time to the duties of the position.

In addition to the general supervisory powers mentioned above, the Board has the right to examine the district banks. It also supervises and regulates the

THE FEDERAL RESERVE BANK OF NEW YORK—This giant building houses New York City's Federal Reserve Bank, which does business with the government, with other Federal Reserve banks, and with member banks in the Second Federal Reserve District, comprising New York State. This, therefore, is a bank for bankers only.

issue of Federal Reserve notes. It has considerable power over the district banks and can suspend the operation of any or all of them if there seems to be good cause.

Amendments to the Federal Reserve Act.—From time to time since its passage, the Federal Reserve Act has been amended in order to strengthen the system. In 1927 an act was passed which permitted national banks to establish and operate branches at any point within

a state if such operation is allowed the state banks by state laws. This means that now national banks may do all that state banks may do; they are no longer at a disadvantage with the banks that are not in the system.

What Has the Federal Reserve System Accomplished?—The Federal Reserve System was established just before the First World War began. When we entered the war, the system had barely begun to function properly. But in spite of this, the system has done much to improve the banking situation and has aided the government in some difficult financing.

It Has Made Our Currency Elastic.—One of the main reasons for setting up the new system was to provide for an elastic currency. In this respect the system has accomplished its purpose by means of the Federal Reserve notes which were described in Chapter XII.

It Has Improved Facilities for Rediscounting.—The system has made available to member banks facilities for borrowing and for reborrowing which did not exist under the former system. The act of 1932 freed the banks from restrictions which were causing funds to be tied up for long periods of time; it made it easier to obtain Federal Reserve notes and to have cash available for needs.

Reserves Have Been Centralized.—Instead of the old practice of piling up reserves in a few banks in the larger cities, where they could not be obtained without serious consequences to other banks, the reserves of the member banks are now kept in the vaults of the twelve district banks. It is now possible to obtain these reserves quickly, and they can be moved to any point in the system at any time they are needed.

It Has Developed Open Markets for the Sale of Securities.—By "open market" is meant all individuals, corporations, banks, and other institutions that buy and sell securities in competition. When the district banks wish to ease credit conditions, they go into the open market and buy securities, thus increasing the supply of credit and money in the district. When they wish to reduce the supply of credit, they go into the open market and sell securities. This reduces the supply of credit and money in a district.

Federal Home Loan Banking System.—Because of the situation which existed in 1932 regarding mortgages on homes which member

banks held and which they were unable to turn into cash, a new system of banks was established known as the Federal Home Loan Banking System. The purpose of this system is to rediscount home mortgages held by building and loan associations, cooperative banks, savings banks, and insurance companies. It serves these institutions in much the same way that the Federal Reserve banks serve commercial banks: that is, by acting as a wholesale credit agent from which its member banks can borrow on the security of their own loans to their own customers.

The country is divided into twelve districts with a home loan bank in each district. These district banks are owned by the member banks and operate with funds obtained from the sale of stock to member banks and of bonds sold to the public. Member banks are permitted to borrow from the district banks upon their notes secured by sound home mortgages. Each district bank has eleven directors, who are residents of the district and who are familiar with local conditions. At the head of the system is a board of five members who supervise all the district banks.

In addition to making mortgage credit reserves available to the members of the system, it controls the *Federal Savings and Loan Associations*, which make local home loans, thus being practically savings banks through which homeowners may obtain loans. It has established a *Federal Savings and Loan Insurance Corporation*, which insures funds up to \$5,000 for millions of those who are putting their money into the Federal Savings and Loan Associations. It is now possible for an individual to deposit funds in a Federal savings bank toward payment of a mortgage and to be protected up to \$5,000.

Recent Banking Reforms.—In spite of the banking laws that had been passed to regulate banking and to protect business, conditions in 1933 became so serious that the President closed all banks in the country. We need not go into details as to the cause for this situation further than to say that thousands of banks had closed their doors and distress was felt by thousands of those who had placed all their savings in these banks. Something was wrong with the banking world and measures were taken to improve conditions. We can describe these changes only briefly.

Banking Act of 1933.—This act contained many provisions. Among them were the following: (1) The Federal Deposit Insurance Corporation (FDIC) was created as described in Chapter XV. (2) Com-

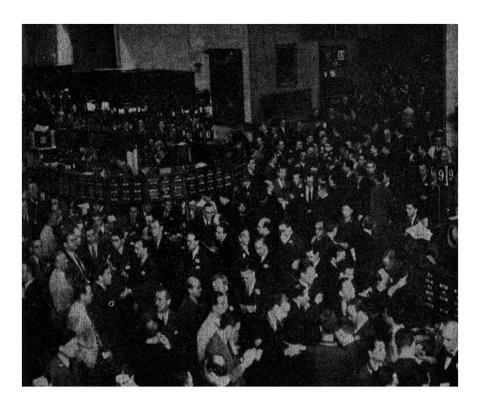
were to confine their business to the granting of short-term credits. (3) Banks were forbidden to make loans to their own officers. (4) Private bankers were forbidden to accept deposits. They must choose between doing an investment business or a commercial bank business. (5) The Board of Governors of the Federal Reserve System was empowered to suspend any member bank that continued to extend credit for speculative purposes after warnings. (6) Payment of interest on demand deposits was forbidden.

mercial banks were forbidden to engage in investment banking and

Banking Act of 1935.—Confidence in the banking system was still at a low point and many complaints were heard about the failure of the Federal Reserve System to prevent the crisis that had developed. In 1935 Congress passed an act intended to reform several of the banking practices and to restore confidence. Among the chief provisions of this act were the following: (1) The FDIC was made permanent and the amount insured was placed at \$5,000. (2) The Federal Reserve Board was abolished and in its place was set up a Board of Governors. This has already been explained. (3) A Federal Open Market Committee was created to regulate all open-market operations of the system. No Federal Reserve bank can now engage in open-market operations without the approval of this committee; nor can any district bank refuse to buy and sell in the open market when ordered to do so. (4) It made it possible for any sound asset of a bank to be used as collateral for obtaining loans. There were other provisions which are too technical for our purposes.

Stock Exchanges Undergo Regulation and Control.—Closely allied to banking is trading on the stock exchanges. Unlike banks, however, stock exchanges were free to make their own rules and were responsible to no public authority. After the crash of 1929, many felt that the losses suffered could have been prevented had there been more control over the exchanges. An investigation showed that some of our biggest investment firms had been selling worthless stock to the public. Other shocking revelations were made. Changes were demanded and as a result Congress took action.

In 1933 Congress passed the Securities Act, which provided for the "full and fair disclosure of the character of securities sold in interstate and foreign commerce and through the mails." Heavy penalties are provided for those who violate this law, which has been called by some the "Truth in Securities Law." In 1934 Congress passed another



Courtesy of New York Stock Exchange, Photo by Gottscho-Schleisner

THE NEW YORK STOCK EXCHANGE—Above is a view of the trading floor of the New York Stock Exchange, where orders for the buying and selling of stocks are being taken by member brokers. The oval-shaped booths are posts at which companies conduct their trading.

act called the Securities Exchange Act. This act created a Securities and Exchange Commission (SEC) composed of five members appointed by the President for a term of five years. According to this act it is unlawful for any broker to use the mails in selling listed securities unless the exchange on which they are listed is registered with the Commission, or unless the securities are exempted from registration. The act also sets up new regulations for margin buying. Formerly it was possible for speculators to buy stock by putting up as little as 10 per cent of the purchase price and borrowing the balance. The 10 per cent was known as the "margin." Now the requirement is that at least 40 per cent of the current market price of the security must be paid in cash. The regulation of margin requirements is now in the hands of the Board of Governors of the Federal Reserve System, who may vary the margin requirements for different kinds of securities.

Summary.—Our present banking system is the outgrowth of many years of banking experience. After we became an independent nation, two attempts were made to establish a national bank partly owned by the government. Each of these banks was successful but both failed to be rechartered because of the jealousy of state banks, political opposition, and questions of constitutionality. For a time only state banks functioned. These proved to be weak and were badly managed, resulting in loss to private individuals and to the government. The government then tried the experiment of taking care of its own funds in an independent and subtreasury system.

When the Civil War began, the government found it difficult to finance its operations; it found it necessary to sell bonds and to issue United States notes. There were too many kinds of paper money in circulation; many thousands of state banks were issuing their own notes. In order to finance the war, to enable the government to sell its bonds, and to make the currency more uniform, the national banking system was founded. This system did much to improve banking; it made the currency more uniform; and it stopped the issue of state bank notes. But it had so many serious defects that after years of careful study the Federal Reserve System was established.

Under the new system the legal reserves of banks were centralized, the currency was made elastic, and there developed a better spirit of cooperation among the banks. By means of several amendments which have been made from time to time, the system has been given more power and strengthened in many ways.

Because of the situation in banking and finance which existed in 1933, several laws were passed to reform the banking practices and to restore the confidence of the people in the banks. A deposit insurance corporation was formed to insure the safety of depositors' money; greater control over credit transactions has been given the Board of Governors; security exchanges have been brought under the control of the government; and commercial banks can no longer engage in investment banking.

#### Questions to Test Your Knowledge

- 1. Describe the organization and functions of the First Bank of the United States.
- 2. Why were the first two national banks refused new charters?
- 3. Describe the subtreasury system. What were its weaknesses?

- 4. Give reasons for establishment of the national banking system.
- 5. List the chief defects of this system.
- 6. Explain why the system was called a "panic breeder."
- 7. Why was the Federal Reserve System established?
- 8. Describe its organization.
- 9. State the duties of the Board of Governors of the Federal Reserve System.
- 10. List the accomplishments of the Federal Reserve System.
- 11. What important changes in banking practices were made by the (a) Banking Act of 1933? (b) Banking Act of 1935?
- 12. What is the general purpose of the Federal Home Loan Banking System?
- 13. What was accomplished by the two acts affecting stock exchanges?

#### Questions for Discussion and Application

- 1. What is a centralized banking system? What countries have such a system? Why has there been so much opposition to a centralized banking system in the United States? Is our present system centralized in any way? Explain.
- 2. Discuss the process of rediscounting notes.
- 3. Show how the Federal Reserve System has centralized the banking reserves of the country.
- 4. Discuss the powers of the Board of Governors of the Federal Reserve System. Does this Board exercise arbitrary powers? May it be said that because of the powers of this Board we have a centralized banking system? Explain your answer.
- 5. Review the disclosures made in the Senate investigation of stock exchanges and show how these evils were remedied by the creation of the Securities and Exchange Commission.
- 6. Discuss the need for an elastic currency.

#### Floor Talks and Written Reports

- 1. The Canadian Banking System.
- 2. Need for control of stock exchanges.
- 3. Advantages of a centralized banking system.

#### Topic for Debate

RESOLVED, That a centralized banking system would be more efficient and more stable than our present system.

#### For Further Information

Building America, "Banking," Vol. VI. No. 3.

Gemmill, P. F., "Fundamentals of Economics," Chap. 14.

Graham, F. D., and C. H. Seaver, "Banking; How It Serves Us."

Holdsworth, J. T., "Money and Banking," Chaps. VIII-XII, XX-XXII.

Taylor, H., and Associates, "Main Currents in Modern Economic Life,"

Chap. 20.

#### PROBLEM 21

#### Kinds of Banks

Make a list of all the banking institutions in your community.

- 1. Which of these are
  - a. Commercial banks with Federal charters?
  - b. Commercial banks with state charters?
  - c. Trust companies?
  - d. Mutual savings banks?
  - e. Stock savings banks?
  - f. Cooperative banks or building and loan associations?
  - g. Federal Farm Loan banks?
  - h. Members of the Federal Reserve System?
- 2. Do any of the commercial banks have savings departments?
- 3. Is there a Morris Plan System in your community?
- 4. Which banks are members of the FDIC?
- 5. Which type of bank has the greatest capital?
- 6. Which type has the smallest capital?
- 7. Which banks have safe-deposit departments?
- 8. Is there a clearing house in your community?
- 9. Are there any kinds of banks not listed above? Name them.

## Chapter XVII

# International Exchange of Goods

#### Aims of This Chapter:

To learn what international trade is.

To find out why international trade is important.

To review our foreign-trade history.

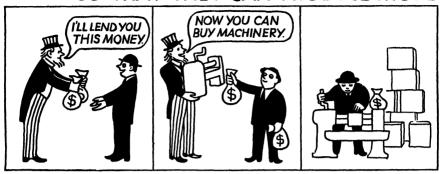
To learn how foreign transactions are settled.

Up to this point in the discussion of exchange your attention has been centered chiefly on trade within our own country, which is called "domestic" trade. Although domestic trade is very important and essential, you should not forget that there is a constant exchange of goods going on among nations. In this chapter you will learn the nature of international trade and how payments are made for goods exchanged in this manner.

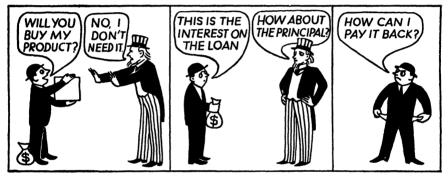
What Is International Trade?—Trade among nations is similar to trade carried on between different sections of a country. Pennsylvania exchanges its coal for the shoes of New England; Michigan exchanges its automobiles for the wheat of Kansas. Likewise Brazil exchanges its coffee, Canada its wood pulp, Turkey its tobacco, and Australia its wool, for the goods of the United States and other countries. Of course, you should understand that this trade is not usually carried on between the governments of these different nations but between merchants and firms of the various countries.

In recent years some totalitarian governments, such as that of Germany, have taken over almost complete control of the foreign trade of their nations. Since becoming involved in the Second World War, Great Britain and the United States, who have long been leaders in world trade, have also been forced to give control of their foreign trade to their governments. To what extent foreign trade will remain under government supervision after peace has been declared and to what extent it will return to the traditional forms of free private

# WE LEND MONEY TO OTHER NATIONS SO THAT THEY CAN PRODUCE MORE



# BUT IF WE DON'T BUY THEIR PRODUCTS THEY MAY BE BANKRUPT AGAIN



AND WE MAY BE LOSERS TOO

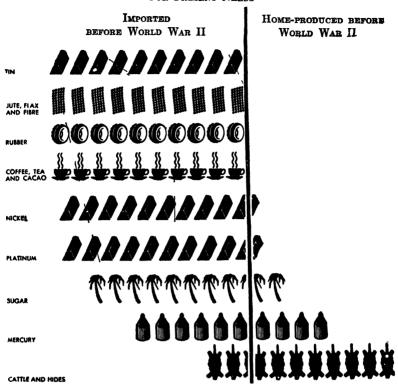
**GRAPHIC ASSOCIATES** 

From Headline Series, Foreign Policy Association

enterprise, no one can say. In this chapter, in discussing foreign trade, we shall have in mind the traditional forms of trade carried on between individuals located in different countries.

Here, then, is a definition you may use: International trade is the exchange of commodities and services between individuals located in different countries.

We have said that international trade is similar to domestic trade. This is true in most respects; but there are a few differences to which your attention should be called. Nations differ in language, in customs, and in their money units. They also differ in the matter of tariff regulations. The problem of the tariff will be discussed in a later chapter.



Each symbol represents 10 per cent of apparent consumption 1925-1929

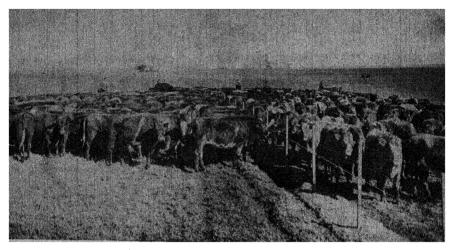
MCTORIAL STATISTICS, SEC.

(From Hacker, Modley, and Taylor, "The United States; A Graphic History,"

Modern Age Books. Inc.)

Why Is International Trade So Important?—It is said that about 90 per cent of our entire trade is domestic and that only 10 per cent of it is foreign. But this 10 per cent is very essential to our prosperity.

When a surplus can be exported, it is possible to prevent an oversupply of these products at home, which might ruin the market for these goods. Exporting them may mean the difference between making a profit or incurring a loss. Indirectly both agricultural and manufacturing exports affect most of the rest of our economic life, because in these days of almost complete economic interdependence, any serious increases or decreases in the buying power of those engaged in agriculture and manufacturing are bound to stimulate or depress



Acme Photo

ARGENTINE BEEF—One-fourth of the world's meat comes from the vast and fertile plains of the Argentine Pampa, which is near the sea and enjoys a mild climate favorable to year-round outdoor grazing. Here the great estancias, estates of several thousand acres engaged in cattle raising, are located.

business as a whole. Thus a serious decline in exports may be one of the factors in bringing on a depression.

Another reason why foreign trade is important to us is that it makes it possible for us to obtain many of the products that we must buy abroad or go without entirely. Among these may be mentioned rubber, tin, jute, silk, coffee, tea, tungsten, and nickel. Many of these articles are essential to the making of goods that are now needed by society and government. Soon after the beginning of the Second World War, we discovered our dependence upon world trade because we had on hand only a small supply of many of the articles mentioned.

Why Do Nations Trade with One Another?—In the paragraphs above we have mentioned one or two reasons why nations trade with one another. But it may be well to repeat them and to add another reason. These reasons are: (1) No nation is entirely self-sufficient. It cannot produce within its own limits everything its people want. For example, we produce no coffee, tea, rubber, or silk. International trade enables us to obtain these goods and thus have a higher standard of living. (2) Some nations tend to produce more of certain goods than are ordinarily used at home. If an attempt were made to dispose of all these goods in the home market, prices would have to be so low that little or no profit could be made. International trade permits a nation to exchange its surplus products. (3) International trade affords an opportunity to buy some goods more cheaply

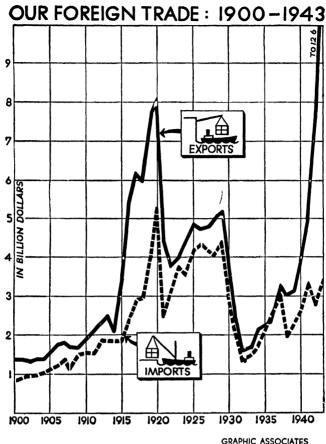
abroad than they can be obtained at home. For example, if England can produce fine woolens more cheaply than we can, it would be wiser for us to buy our woolens from England rather than make them at home.

Why Does One Country Export Certain Commodities and Only Those?—The reason is that the exporting country has some advantage over other countries in the production of these commodities. It can produce these commodities at a lower cost than competing countries. America exports wheat, cotton, petroleum, and copper; Argentina exports beef; Australia wool, and so on. In each case there is some great advantage due to climate, soil, machinery, or labor. A great deal of foreign trade is carried on not because a country would be deprived of these goods if there were no such trade but, rather, because in the production of an article that can be produced in two countries, it is often more profitable for one country to yield to the other; that is, the country less favorably equipped to produce a certain article gives way to a country that is especially well prepared to produce that article. This latter country thus specializes in making this article. It produces enough not only for itself but for the other country as well. In this way both countries benefit.

This important principle of foreign trade is called the *principle* of comparative advantage, which may be stated thus: Each country will produce for export those commodities which it can produce most cheaply, and will import those commodities which other countries produce more cheaply.

Foreign Trade of the United States.—The United States has always been rich in natural resources and this is one of the reasons why European countries were interested in developing our country. We were the source of supply of many things that were not available or could not be obtained so easily or cheaply in Europe. Thus from earliest times our country has had an interest in foreign trade. For many years we supplied other countries with furs, fish, lumber, minerals, tobacco, grain, and cotton. In the production of all these commodities we had advantages over European countries. Before 1860 American industries were largely confined to primary production. The greater part of our population was engaged in farming, lumbering, fishing, cattle raising, and mining. We depended to a large extent upon other countries for our manufactured goods.

As far back as the War of 1812 we began certain developments which were ultimately to enable us to cut loose from Europe and



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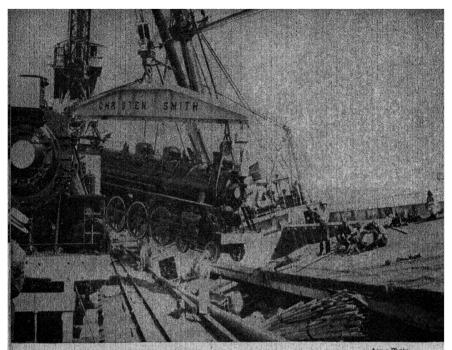
become self-sufficient. We began to build factories and to engage in manufacture on a small scale. Then came the Civil War, which hastened our industrial development. With our abundance of natural resources we soon developed industries that were producing more than we could use ourselves. We had manufactured goods for export. At the end of the nineteenth century large-scale production had reached such proportions that larger markets were required. The position of the United States became more important, and our foreign policy was concerned with markets for manufactured goods as well as for raw materials.

In the twentieth century we have redoubled our efforts to find markets for our manufactured goods and farm products. Our leading exports have been made up chiefly of farm products, leather and leather goods, iron and steel products, oil, coal, cotton and cotton goods. We have sold abroad millions of dollars' worth of American reapers, cash registers, typewriters, and automobiles. At the same time we have imported such articles as coffee, tea, rubber, tin, nickel, platinum, potash, and certain fine quality goods such as works of art and fine handicraft. Our foreign trade was on the upward trend when the First World War began in 1914. Thereafter, we were called upon to supply the warring countries with foodstuffs, raw materials, and munitions of war. During the first years of that war, we were the largest neutral nation. Our foreign trade boomed.

Foreign Investments of the United States.—After the First World War, our foreign trade continued until the crash came in 1929. We were supplying certain European countries with vast quantities of materials and equipment to be used in restoring their devastated lands. Our banks also lent large sums abroad to be used for the purchase of these commodities. This does not mean that money from our banks was actually sent over to Europe and then sent back to our manufacturers for goods purchased. Our banks simply gave "credits" to European governments and concerns and then charged these Europeans with debts on the books of the banks. As the goods were shipped to Europe, our banks paid our manufacturers for them. Later on, some of these debts were "defaulted." In such cases the losers usually were not the manufacturers who furnished the goods or the taxpayers of the United States, but the banks who had made the loans or the investors who had bought the foreign bonds.

Our government had also made loans to European governments, during and shortly after the First World War, and some of these loans also were defaulted. These defaults did affect our public debt and, through that, our taxpayers. But it is important to keep in mind these various kinds of transactions, since such terms as "we," "they," and the names of foreign nations used in discussions of foreign trade obscure the fact that the greater part of foreign trade consists of transactions between banks, shippers, manufacturers, and other private concerns for which governments and peoples are not responsible.

Governments and peoples were responsible, however, for the high tariffs and "quota" systems that were set up by many nations, including our own, in the late 1920's and early 1930's. These choked off the free flow of international trade, interfered with the payment of international debt, and brought the whole system of international exchange to disaster.



Acme Photo

LATIN AMERICAN TRADE—South American markets are becoming essential to our export business. After the outbreak of the Second World War, the trade relations of South American firms with European countries were cut off or restricted, and the Americas grew more and more interdependent. Above, a locomotive is lifted aboard ship in Philadelphia, bound for Chile.

Why Did Our Foreign Trade Decline?—A "quota" system is a method of limiting the amount of goods that can be bought from other countries. This system, when adopted by other countries, had the effect of cutting down our exports. Our foreign trade began to decline. The desire to become self-sufficient is called *nationalism*. Under nationalism all inhabitants of a country are expected to support home industries and to buy only home products. Thus, in spite of the lending of large sums to enable other countries to buy from us, our trade continued to decline. This was reflected in the distress of our farmers and workers in industry and prolonged the depression.

With the outbreak of the Second World War our trade suffered another blow. Country after country was closed to our merchants. American ships were forbidden by our neutrality laws to enter certain ports. In order to improve our foreign trade, we sought new markets in Latin America. This trade increased greatly during the Second World War.

How Did the Second World War Affect, Foreign Trade?—The Second World War brought many changes in the foreign trade of the United States and in the control of this trade by the Federal government, though some of these changes occurred before our actual entry into the war.

One of the first steps taken was to create stock piles of strategic and critical materials, such as tin, rubber, silk, tungsten, quinine, nickel, and several other commodities. Special governmental agencies were organized to accumulate stocks of various materials. We also entered into agreements with Latin American countries for the purchase of their available supplies of certain strategic and critical materials.

In 1940, we "froze" the assets of several foreign countries. This prohibited within the jurisdiction of the United States all transactions in which the country or its citizens had any interest. The process was extended to country after country as Germany continued to be victorious; it also extended to Germany, Italy, and Japan. All exports and imports between the United States and any country whose assets were frozen was automatically prohibited, unless our government saw fit to issue licenses for specific transactions. The freezing orders were not applied to Latin America, but in 1941 the United States listed the names of persons and firms believed to be nationals of or sympathizers with the Axis countries and located in the countries of the Western Hemisphere. Our government forbade all business and financial transactions between citizens and residents of the United States and listed persons and firms, unless permitted by licenses issued by the Treasury Department.

Other measures subjected our foreign trade to direct control of the government. The export control system was originally intended to apply to certain essential raw materials, machine tools, arms, ammunition, and war goods in general. However, the list was increased rapidly, until finally practically everything included in our normal list of exports came under the ban. The export control system prevented other countries from buying here raw materials and goods which were needed in our own war program, but it permitted us to send all kinds of goods to the countries of the Western Hemisphere which collaborated with us.

In 1941, the so-called Lend-Lease Bill was passed. This authorized the President to "sell, transfer title to, exchange, lease, lend, or otherwise dispose of various defense goods" to other countries whose defense was deemed vital to the defense of the United States. The lend-lease policy overcomes the objections which arose because of our method of giving aid to our allies in the First World War. Our allies in the Second World War borrow no funds and have no foreign-exchange problem. No problem of monetary war debts has been created to cause us trouble after the war. The Act specifies that lend-lease aid may be given under any terms and conditions agreeable to the President, and that the resulting benefit to the United States "may be payment or repayment in kind or property, or any other direct or indirect benefit which the President deems satisfactory."

Our foreign trade has increased greatly under these measures, but it has taken a new direction and more of our goods are now coming from Latin America and from the industries we have built up here and in Latin America to provide the essential materials. The effects of these changes upon the future of international trade of the United States cannot be foreseen at the present time. No doubt, after peace, there will be many problems of trade and exchange to be settled.

What Items Are Exchanged among Nations?—International trade is made up of exports and imports. Exports are the goods sold to other countries and sent out of the country; imports are goods bought from other countries and brought into the country. It is customary to divide exports and imports into two groups: visible and invisible items.

Visible items are the actual commodities that are exported and imported. They cannot be moved without being seen and are usually taxed when they enter a country. They consist of such things as cotton, machinery, or automobiles.

*Invisible items* consist chiefly of services and thus are not readily seen. They are usually grouped under five headings.

- 1. Freight charges.—These result from services performed by people of one country for those of another. Ocean freight includes American goods carried in vessels of other countries and foreign goods carried in American vessels. These freight charges enter into the foreign trade of any country.
- 2. Expenditures of tourists.—When Americans travel abroad, they spend money for many items; when tourists come here, they likewise spend foreign money. It is estimated that in 1937 American tourists

spent a total of about 600 million dollars in foreign countries while, in the same year, tourists spent only 160 million dollars here.

- 3. Remittances of immigrants.—Many immigrants who have found work here send part of their savings to relatives in the countries from which they came. Such remittances build up European purchasing power to demand American exports.
- 4. Interest and dividends on private investments.—In normal times it is customary for investors to buy foreign securities. At stated intervals, interest and dividends are paid on these securities. When Americans receive dividends from abroad, such dividends are American imports; when residents of other countries receive income from their American investments, these are American exports. In 1937 it is estimated that Americans received in this way about 608 million dollars while residents of other countries received from us in this way about 278 million dollars.
- 5. Government transactions.—Although international trade is carried on almost entirely among individuals in different countries, it does happen that governments occasionally buy from other governments, spend money in other countries, and lend to foreign nations. For example, our government spends large sums of money to maintain its ambassadors, ministers, and consuls in other countries; likewise, other countries maintain their official representatives here.

What Is a Balance of Trade?—When the exports of a country just equal its imports, the trade is said to be balanced. When a country buys more from other countries than it sells to them, it is said to have an "unfavorable" trade balance. But when a country sells more to other countries than it buys from them, then its balance is said to be "favorable." It is usual to consider only the visible items in determining the balance because these items can be seen and measured. But the invisible items form a very important part of foreign trade although they cannot be valued so easily as the visible items. Thus it frequently happens that the so-called "balance of trade," whether favorable or unfavorable, is not always so unbalanced as figures of exports and imports would seem to indicate.

How Are International Transactions Settled?—Foreign trade is carried on by the use of international bills of exchange. Each country has its own monetary system, and the merchants who sell goods



#### A FOREIGN BILL OF EXCHANGE

abroad for foreign money must find some means of exchanging their foreign money into the money of their own country. In normal times this is done by banks that deal in foreign exchange. When an American merchant sells goods to a foreign dealer, he wants his payment in dollars while the customer may have only pounds sterling. Instead of payment by check, the bill of exchange is used. A bill of exchange is nothing more than a written request for the payment of money, except that it may involve the exchange of one currency for another. Let us take a typical case.

The Acme Company of New York sells a number of refrigerators to John Martin in Manchester, England. Since the Acme Company is an American firm, it naturally expects to be paid in dollars, so it draws a bill of exchange in favor of its bank, the Chase National Bank. The bill of exchange, together with such trade and shipping documents as bills of lading and consular invoices, is taken to the bank, where it is discounted. This means that the Chase National Bank,

after deducting a charge for its services and for interest for the time specified in the bill, pays the Acme Company immediately, expecting to collect from Martin when the bill comes due. The Chase National Bank sends the bill of exchange and the documents to a bank in Manchester with which it has connections, a "correspondent" bank as it is called, and this bank presents it to Martin for payment. As soon as Martin accepts the bill of exchange, that is, agrees to pay it, the bank in Manchester delivers the shipping documents to Martin, who may now obtain the refrigerators from the shippers. Martin has only British money so he has to pay the bill to the Manchester bank in pounds sterling at the current rate of exchange. The Manchester bank; having obtained payment in pounds sterling, now owes the Chase National Bank the amount expressed in the bill in dollars. The Manchester bank really gets the pounds from the English buyer while the Chase National Bank paid the American seller in dollars.

The debt of the Manchester bank to the Chase National Bank can be settled by a reverse operation. An American importer of English woolens must pay pounds in Manchester. To meet this obligation, he may pay the equivalent in dollars to the Chase National Bank.

Summary.—International trade, in the traditional sense, is the exchange of commodities and services between individuals located in different countries. There are many similarities between international trade and domestic trade; but there are some differences. Nations differ in language, in customs, in their money units, and in tariff regulations. Nations trade with one another because they can thus obtain goods which they are unable to produce themselves; they can also dispose of surpluses; and they can obtain some goods more cheaply abroad than they can at home. A country specializes in the exporting of some commodities because it has certain distinct advantages in the production of these goods, owing to climate, soil, machinery, or labor.

International trade is made up of exports and imports. These are made up of visible and invisible items. Visible items of trade are those things which are material or physical. The invisible items are intangible and consist of freight charges, tourists' expenditures, immigrant remittances, interest on private investments, and government transactions.

International trade is financed mainly through bills of exchange. Gold itself was formerly shipped to balance accounts. Although the system of foreign exchange is complicated, banks have worked out means that render exchange fairly convenient. In the long run, goods are paid for by goods; that is, exports pay, in large part, for imports.

### Questions to Test Your Knowledge

- 1. Define international trade.
- 2. What differences exist between domestic and foreign trade?
- 3. Why is international trade important?
- 4. Give three reasons why nations trade with one another.
- 5. Why does a country specialize in the exportation of certain commodities?
- 6. Distinguish between imports and exports.
- 7. Name several invisible items of foreign trade.
- 8. Explain what is meant by balance of trade.
- 9. What methods are used in settling international trade balances?
- 10. What is a foreign bill of exchange?

#### Questions for Discussion and Application

- 1. "No country today can be self-sufficient." Discuss this statement.
- 2. Give a brief account of the foreign-trade experience of the United States.
- 3. State and illustrate the principle of comparative advantage.
- 4. Distinguish between a favorable and an unfavorable balance of trade. Is it always disadvantageous for a country to have an unfavorable trade balance? Explain why or why not.
- 5. Why are so-called trade balances not too reliable?
- 6. Summarize the situation regarding our foreign trade brought about by the Second World War.

#### Floor Talks and Written Reports

- 1. American foreign trade.
- 2. The lend-lease program.
- 3. Future of international trade.

#### Topic for Debate

RESOLVED, That it is essential to the existence of any country that it sell abroad more than it buys abroad.

#### For Further Information

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## Chapter XVIII

# Obstacles to Trade

#### Aims of This Chapter:

To find out what a tariff is.

To examine the kinds of tariffs.

To discuss arguments for and against protective tariffs.

To sketch briefly our tariff history.

To learn how tariffs are made.

In our discussion of trade, both domestic and international, little was said about the obstacles that have been placed in the way of trading. We have stated that different languages, customs, money units, and tariffs were hindrances to trade. Countries also have erected barriers against the trade of other countries, and these barriers are called tariff "walls." In this chapter we shall learn about their effects upon the free exchange of goods.

What Is a Tariff?—From very early times countries engaged in trade have placed a tax upon the goods entering their countries from other lands. Some countries have even placed a tax upon goods which leave their ports, but this is impossible in the United States because the Constitution forbids it. A tax placed upon goods that are brought into a country is called a tariff.

Tariffs are imposed for two reasons: (1) to provide revenue for governmental purposes and (2) to protect home industries from the competition of cheaper goods from abroad.

What Kinds of Tariffs Are There?—There are three kinds of tariffs: (1) a tariff for revenue only, (2) a protective tariff, and (3) a tariff for both reasons.

A tariff for revenue only is levied primarily to bring in revenue with which to operate the government. Its chief purpose is to increase the income of a country by taxing goods as they enter that country. It

is usually levied upon goods which are not produced within the country but which people demand and will buy in spite of the tariff. If the United States should levy a tariff on rubber or coffee, it would be for the purpose of raising revenue.

A protective tariff, as the name implies, is levied primarily for the purpose of protecting something. It is imposed to protect the workers of a country against the competition of foreign laborers who are paid much lower wages; or it is imposed to discourage the importation of certain goods which compete with the goods produced in the country levying the tariff. When such a tariff is imposed, it is with little thought of revenue, although some revenue is obtained.

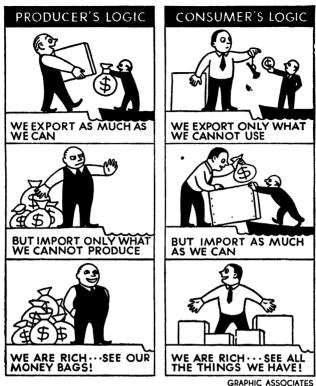
How Are Tariff Duties Levied?—It is customary to call the taxes levied on imported goods customs duties. These customs duties are not all levied in the same way. If the tax is imposed in accordance with the value of the goods, it is called an ad valorem duty. If the tax is levied according to the physical quantity of the goods, it is called a specific duty. Thus, a tax of 15 per cent of the value of an article is an ad valorem tax; while a tax of 3 cents a pound, 25 cents a bushel, or 50 cents a cubic foot, is a specific tax. Some tariffs are compound duties; that is, they are both ad valorem and specific.

What Are the Pros and Cons of the Tariff Argument?—The protective tariff is the kind that has caused the greatest amount of argument pro and con. There are those who favor a protective tariff for various reasons, and there are those who are opposed to such a tariff. Space does not permit us to give all the arguments, so we shall outline briefly only the best known ones.

Tariffs Enable Our Infant Industries to Become Strong.—This is called the "infant-industry" argument. New industries are constantly being established in the United States which are in competition with well-established industries in other countries. It is argued that a protective tariff is needed to enable these new industries to become established and to meet competition. After the industry is assured of life, it will be able to take care of itself and the tariff can be removed.

This argument won much support at the time we were beginning to set up our own manufacturing industries. It was not difficult to make people see that protection was needed for these industries. But now several of the industries which were protected by a tariff for a

#### HIGH TARIFF VS. LOW TARIFF



From Headline Series, Foreign Policy Association

while have become strong enough to compete with industries anywhere in the world.

Those who oppose a protective tariff maintain that this argument is weak because some infant industries have continued to demand protection long after they have become strong enough to compete with rival foreign industries. They also maintain that it is not safe to assume that a particular infant industry will grow strong even if it is protected; if it can never stand on its own feet, it is foolish to attempt to nurse it.

Tarijīs Stimulate Demand for Home Products.—This is the so-called "home-market" argument. Those who support this argument claim that a protective tariff will lead to the establishment of more industries, which will employ more workers, who will purchase more agricultural products. Thus our farmers will be benefited by a large home market at good prices and will not be obliged to seek foreign markets for

their surplus. It is also claimed that the home market is a sure market because it is not upset by wars and by the tariff regulations of other countries.

Those who oppose protective tariffs maintain that there is no proof that the home market is surer or more stable than foreign markets. They claim that with only a home market for farm products, an unusually heavy crop may easily oversupply the market and cause such low prices that farmers will lose in the end. But if there is a world market, there is an outlet for the surplus and the home market is not upset. They argue further that when one country erects a tariff wall against another country, there is retaliation. Foreign countries whose goods are excluded by a tariff tend to close their markets to the goods of the country which excludes their goods. This leads to friction. It is a familiar truth that a nation that wishes to sell to others must be willing to buy from others.

Tariffs Help Us to Maintain a Higher Standard of Living.—It is a well-known fact that American workers have the highest standard of living of workers anywhere in the world. Supporters of protective tariffs claim that this is due to the fact that we pay higher wages than any other country. If the industries that employ these workers had to compete with foreign industries that pay low wages, it is claimed that our workers would have to accept less employment or lower wages. This would mean a lower standard of living. The protective tariff, by increasing the price of the imported article, or by excluding it entirely, will permit our industries to sell at a higher price and thus be able to maintain a high wage scale. These people maintain that a protective tariff raises the wage level.

These arguments are attacked with vigor. Opponents claim that wages are not high because of the tariff but for other reasons not related in any way to a tariff. These reasons are our natural resources, our skilled workers, the use of machinery, and our superior management of business. Many are willing to agree that wages may be kept high in protected industries, but they believe that workers make no gain thereby because they have to pay more for everything they buy on account of the increase in prices. The argument favoring a tariff because it raises wages is attacked by its opponents, who claim that only about 10 per cent of our workers are employed in protected industries and so only a very small proportion of them receive any benefit from the tariff.

Tariffs Make Us Independent and Self-sufficient in Time of War.—This is called the "national-defense" argument. It is claimed that a nation should be self-sufficient and that it should not have to depend upon any other country for some of its essential needs, especially in time of war. This applies not only to food but also to those things needed for military purposes. It is pointed out that when we entered the First World War we found that we were dependent upon Germany for our dyes, on Chile for our nitrates, and on several other countries for many essential products. During and before the Second World War we again found that we were dependent upon other countries for critical materials, such as rubber, tin, bauxite, and many others. It is said that if we had encouraged more industries by a tariff shutting out foreign products, we should have been less dependent.

Those who disagree with this line of reasoning claim that it is not possible for any country to become self-sufficient to any great degree and that the appeal to nationalism is a selfish one that causes only hatred and war. They also claim that there is always danger that, under cover of military necessity, tariffs will be built up for selfish purposes of profits rather than for national needs of security and self-sufficiency.

Tariffs Prevent the Dumping Here of Cheap Goods.—By "dumping" is meant the practice of selling goods abroad for a lower price than that which prevails at home. It is claimed that a protective tariff will prevent this practice on the part of foreign countries.

But the mere fact that a foreign country may be able to flood the American market with cheap goods does not constitute dumping. It is dumping only when the cheapness of the goods represents a lower price to the importer than the current price in the home market of the exporter.

Dumping is resorted to for three purposes: (1) to get rid of a temporary oversupply of goods which, if sold in the home market, would ruin it; (2) to create a regular outlet for the manufacturer's surplus so that he may continue to run his plant at full capacity; or (3) to put a rival manufacturer out of business. If the dumping serves to drive a competitor out of the market and the price is then raised, there is some reason for a tariff that will stop this. Practically all countries have resorted to dumping at times, the United States no less than others. There is little disapproval of a tariff that will guard against dumping, but the difficulty is to devise such a tariff which will not interfere with legitimate trade.

Tariffs Encourage Monopolies.—Those who are opposed to protective tariffs claim that such tariffs tend to encourage monopolies because they restrict the market to domestic goods. When foreign competition has been eliminated, protectionists claim that competition will continue between the various industries within a country. But opponents maintain that instead of competition, combination of industries results. They insist that the tariff is the "mother of trusts."

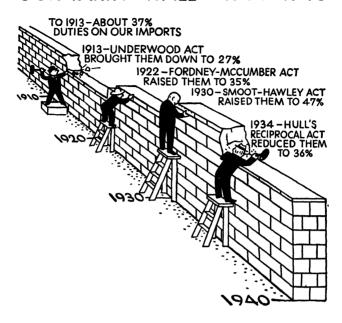
Tariff History of the United States.—The tariff history of the United States may be divided into three periods: (1) from 1789 to 1815; (2) from 1815 to 1860, and (3) from 1860 to the present.

From 1789 to 1815.—When the Constitution was adopted in 1789, Congress was given the power to regulate foreign commerce, and it at once drew up a tariff law. The tariff of 1789 was the first one in our history. From this date to 1815, all the tariffs were relatively low and in general of the revenue type because the government was more interested in raising money for current expenses than it was in protecting industries.

From 1815 to 1860.—The second period was marked by increasing protective tariffs up to 1833; from then on to 1860 the trend was toward lower tariffs. During this period we were building up our new industries, and tariffs were made to protect these infant industries. About 1833 the South began to feel that protection was harmful to its interests, which were mainly agricultural, and it began to oppose such tariffs. Several bitter struggles ensued over this issue with the result that rates were reduced gradually and remained fairly low until the Civil War began.

From 1860 to 1934.—The third period of our tariff history is marked by an almost unbroken series of protective tariffs with the rates steadily increasing. During the Civil War, and for a while after, the rates were very high because the government used every means to raise large sums of money to meet the expenses of the war. From the end of the war to the present time there has been a succession of tariff laws, which, with two exceptions, in 1894 and again in 1913, rose to ever higher levels. The McKinley tariff of 1890 raised the level of duties by nearly 50 per cent. The Dingley tariff of 1897 raised the general level by 57 per cent, which was the highest until the Fordney-McCumber tariff of 1922 and the Smoot-Hawley tariff of 1930. The latter is the highest tariff we have had in our history.

# OUR TARIFF WALL-1900-1940



GRAPHIC ASSOCIATES
From Headline Series, Foreign Policy Association

OUR TARIFF WALL—This cartoon shows the variations in our tariff policy for forty years. What happens each time a change occurs in the height of the wall?

How Are Tariffs Made?—Tariff acts are passed by Congress and signed by the President. Before a final vote is taken on a proposed tariff, many hearings are held at which arguments are heard from all sides. These hearings are before the committee which has the duty to consider all the evidence and then report the bill to Congress itself. But it seldom happens that a tariff bill is made a law in just the form in which it was first presented. The final bill is a compromise. In a large country like the United States there are many sections with conflicting interests. Each section wants the tariff to contain rates that favor its industries. In order to obtain as much as possible in the way of favors, compromises are made with other sections; the result is that a tariff is not made in accordance with the best interests of the entire country. It results from particular political influences and does not represent general economic interest.

Tariff Commission.—In order to remove the making of tariffs from politics, Congress has three times provided for a tariff commission,

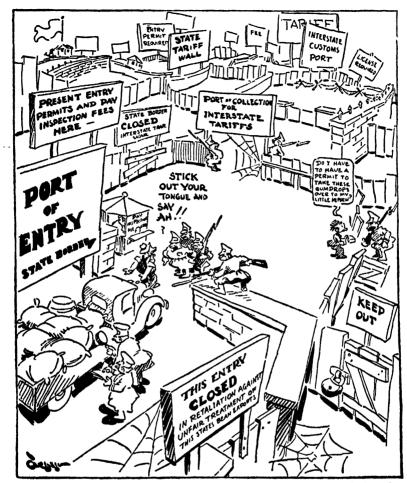
once in 1882, again in 1911, and once more in 1916. The commission established in 1916 was given certain specific duties. It was to investigate the workings of the tariff law in this and in other countries, to study the entire history of our tariff relations with other countries, and to compile tariff information for the guidance of Congress in drawing up tariffs.

In 1922 the commission was given a new duty. This was to advise the President in the use of his discretionary power to modify the rates that are to be applied to the imports from any particular nation. The commission has performed its duties and has presented statistics to Congress, but Congress has not chosen to follow the recommendations.

"Flexible" Clause in Tariff Laws.—In 1922 a change was made in our tariff law which gave the President the power to raise or to lower the existing rates not more than 50 per cent. The primary purpose of the change was to prevent the dumping of foreign goods in our markets. The power to make these changes has been exercised by several presidents in the interests of our industries and better relations with other countries.

Reciprocity.—In tariff making reciprocity means an agreement whereby one country grants to another country certain favors in return for similar favors. After our tariff act of 1930 went into effect, foreign nations began to retaliate against us by raising their own tariff rates. They also established "quotas," which were unfavorable to us. The result of these actions was to reduce our foreign trade and to create ill will among nations.

In order to regain some of our lost trade and to improve international relations, Congress, in 1934, passed the *Trade Agreements Act*. This act permitted the President to negotiate trade agreements with other countries. These agreements did not have to be approved by the Senate since they were not regarded as treaties. Nevertheless, agreements made with one nation were held to apply to other nations. Under this act we have negotiated agreements with twenty-five nations and more were pending when the Second World War began. Most of the agreements have been made with countries whose goods supplement rather than compete with our own goods. Because of the war and the stoppage of almost all trade among nations, it is not yet possible to determine how much good these agreements may have done; but they are considered by many as a step in the right direction



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INTERSTATE TRADE BARRIERS—This cartoon will give you some idea of the barriers that have been erected between some of the states.

to lower trade barriers and so bring about more peaceful relations among nations.

Do Our States Erect Barriers against Each Other?—It is not only in international trade that barriers have been erected. Some of our states have raised obstacles to the free shipment of goods. This may seem surprising in view of the geographical fact that the United States comprises the greatest free-trade area in the world, and in view of the constitutional provision which places interstate commerce and tariffs under the control of Congress.

Although the Constitution does not permit states to levy tariff duties on imports or exports or to discriminate against the trade of other states, several states have passed laws and regulations that tend to prevent the free movement of goods between states. Although none of these regulations is a tariff law, they have the same effect. A few illustrations will be sufficient.

Many states urge their citizens to buy only goods produced within the state; some states require that all public printing contracts be given only to firms within the state; many states have erected barriers to interstate trucking. Ten states have ports of entry for the purpose of collecting ton-mile taxes on interstate trucks; forty-seven states require that only butter made in the state shall be served in state institutions. Several states forbid the sale of oleomargarine within their borders.

It is now recognized that these restrictions injure outside producers and indirectly reduce the outside demand for the products of the state. They also cause much ill feeling among the states. Accordingly, steps have been taken to remedy the situation.

In 1939 the Council of State Governments assisted by the Federal government started a campaign to eliminate interstate trade barriers. The campaign has had good results. The most recent suggestion is that the Council of State Governments undertake to remove trade barriers by measures similar to the reciprocal trade agreements of the national government. With patience it is hoped that soon the states will respond in the interest of greater national unity and better trade relations among them.

Summary.—Placing a tax upon goods brought in from other countries is not a new practice. It has existed for centuries and has become more serious as nations have increased their trade and have looked for foreign markets for their surplus goods. Taxes placed upon foreign goods entering a country are known as tariffs. These tariffs are levied for revenue or to protect the manufacturers of a country against the products of another country.

Those who favor protective tariffs claim that they enable infant industries to become strong; that they stimulate demand for home products; that they help us to maintain a higher standard of living; that they make us self-sufficient in time of war; and that they prevent the dumping of cheap goods in our markets. Opponents of protective tariffs find weaknesses in all these arguments and make the further claim that such tariffs encourage monopolies.

Our tariffs are not made scientifically but are the result of many compromises among the various sections of the country. As an aid to Congress in the making of tariffs, the experiment of creating a tariff commission has been tried. Another method of adjusting tariff rates has been the use of the flexible clause by which the President is authorized to raise or to lower rates in accordance with recommendations of the tariff commission. Most recently the experiment of reciprocal trade agreements has been tried. The tariff problem is far from solution and will continue to be a source of friction among nations unless some nation takes the lead in lowering tariffs in the interest of world peace and trade.

Our states have erected trade barriers which have the same effect as tariffs. By means of regulations and laws states have made it more difficult to carry on trade between the various states. But efforts are being made to eliminate these barriers and in time it is hoped that interstate trade will be absolutely free again.

## Questions to Test Your Knowledge

- 1. What is a tariff?
- 2. Why are tariffs levied?
- 3. Explain the two kinds of tariffs used in the United States.
- 4. Distinguish between ad valorem duties and specific duties.
- 5. List the arguments favoring protective tariffs.
- 6. Explain what is meant by dumping.
- 7. Why is dumping practiced?
- 8. What are the functions of the tariff commission?
- 9. Explain how the flexible clause operates.
- 10. What is meant by reciprocity in tariff making?
- 11. Mention several ways whereby states hinder interstate trade.

### Questions for Discussion and Application

- 1. Show how a protective tariff does not make high wages in all industries. Industries were still protected during the depression of 1929–1935. Why were wages not high then?
- 2. Explain how a protective tariff may cause new industries to be established. If the synthetic rubber industry is continued in peacetime, should it be protected by a tariff?

- 3. "Our tariffs have all been compromises." Discuss the truth or falsity of this statement.
- 4. Who actually determines in this country whether an industry shall be protected by a tariff? Who determines the amount of protection that shall be given? Is this a scientific method? Explain.
- 5. Why does a nation seek to be economically self-sufficient? Is such a condition possible today? Is it desirable? Discuss.
- 6. It is said that a country or a locality would be better off economically if the people could be persuaded to buy only home products. What is your reaction to this view?
- 7. Discuss the effects of the Hull trade agreements on our foreign trade and on the establishment of more peaceful relations among nations.
- 8. Show that the various measures adopted by the states regarding trade between the states are hindrances to national unity.

#### Floor Talks and Written Reports

- 1. Reciprocity vs. retaliation.
- 2. Interstate trade barriers.
- 3. New infant industries arising out of the war.

#### Topic for Debate

RESOLVED, That tariffs should be made by impartial tariff experts and not by politicians or those with a special interest.

#### For Further Information

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#### PROBLEM 22

#### Inconsistency of Tariff Arguments

In the many discussions of the tariff question various leading statements have been made which seem to contradict each other. Among the commonest

statements made are these: "The tariff is a local issue." "Every purchase of foreign-made goods diminishes the demand for American labor." "The high wages of American workmen make high tariff rates necessary to protect the American manufacturers that give these workmen employment." "The tariff makes the wages of American workmen high."

- 1. Which sections of the country invariably support or oppose protection?
- 2. How would you expect your Congressman to vote on protection? Why?
- 3. Is his judgment or the interests of his district likely to be the stronger force?
- 4. What is the basis of the second statement in our problem?
- 5. In the long run, how are foreign goods paid for?
- 6. Are the last two arguments in the problem sound? Are they inconsistent? Why, or why not?
- 7. What, in your opinion, is the relation between protection and wages?

#### Part IV

# How the National Income Is Shared

Chapter XIX:

RENT-INCOME FROM LAND

Chapter XX:

WAGES-INCOME FROM LABOR

Chapter XXI:

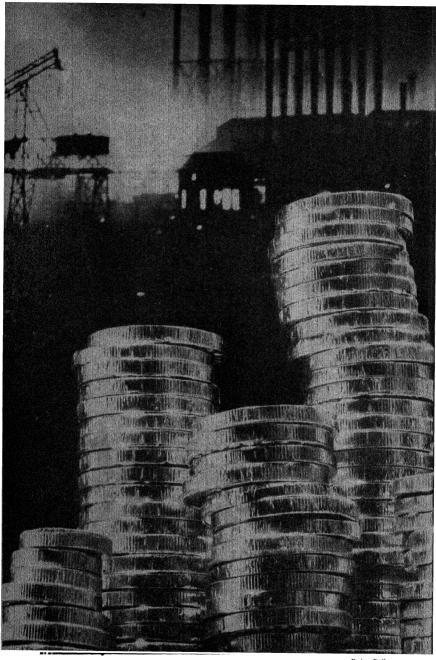
INTEREST-INCOME FROM CAPITAL

Chapter XXII:

PROFITS—INCOME FROM BUSINESS ENTERPRISE

Chapter XXIII:

INSURING AGAINST RISKS



Ewing Galloway

FACTORIES—AN IMPORTANT SOURCE OF INCOME—Our factories turn raw materials of nature into useful products with the aid of labor and capital. The various agencies engaged in producing these utilities or products for our consumption receive income.

## Chapter XIX

# Rent—Income from Land

#### Aims of This Chapter:

To learn what the national income is.

To see who share this national income.

To learn the nature of rent.

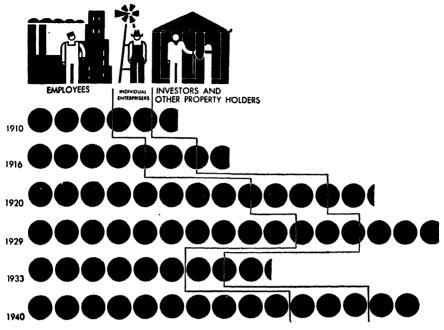
To find out why rent is paid.

To discover how economic rent is determined.

In the section that dealt with the production of utilities in commodities and services, you learned that certain agencies are needed in order that the goods we need may be made available. These agencies are natural resources, labor, capital, management, and government. Each of these agencies performs a useful service in production and expects a share of the proceeds when the goods are sold. It will be the purpose of the next few chapters to find out what is distributed and how each factor obtains its share.

What Is National Income?—The agencies engaged in producing utilities for our consumption do not receive the actual goods as a reward for their services. They cannot use goods in payment of their obligations as these would not be acceptable to others. A worker in a shoe factory, for example, does not want his pay in shoes because he would find it awkward and difficult to exchange shoes for meat and bread and other things he needs. The same is true of other processors of commodities and of those who perform services, such as teachers, dentists, nurses, and doctors. They want something that is readily accepted by everyone in exchange for goods, that is, money. Accordingly, the goods produced by all the workers in the country are exchanged for money and this money is in turn exchanged for other goods. The real income is the flow of commodities and services from production; the monetary income is its expression in dollars and cents.

### DIVISION OF NATIONAL INCOME



Each disc represents 5 billion dollars

PICTOGRAPH CORPORATION

DIVISION OF NATIONAL INCOME—This pictograph shows how our national income was divided among three important groups.

The process of sharing this national income among those who helped to produce it is called distribution.

Who Share the National Income?—As has been stated in the paragraph above, it is the agencies sharing the income that make the production of goods possible. To the share that goes to each agency a different name has been given in economics. The owner of natural resources receives rent; the wage earner receives wages; the capitalist receives interest; management receives profits; and government receives taxes. Before any of the other agencies receives anything the government takes out its share. This is such an important topic that it will be treated in a separate section.

What Is the Nature of Rent?—Our discussion will begin with the share that goes to the owner of natural resources, or land as it is more commonly called. This share is called "rent." Although the term "rent" is familiar to all of you, it is necessary to call your attention to the fact that the word has a meaning in economics that differs from the common understanding of it.

Your parents may be paying rent for the house in which you live; your father may rent the store in which he conducts his business; you may have rented a typewriter for a month or two; or, possibly, you have rented a dress suit for the school prom or a cap and gown for graduation. These instances of rent are common to everyone. You are more likely to hear the term "hire" used in these cases.

The economist uses the term "rent" in another sense. He has in mind the return which any owner of a natural resource receives from its use in production. Men use land, or natural resources, in many ways in order to get some return from it. Farmers cultivate it and raise crops; miners dig in it and extract from it minerals and metals; workers in industries use things grown on the land, or taken from it such as raw materials from which to produce a finished article. Those living in cities use it for the purpose of erecting upon it buildings for homes, offices, factories, or hotels. When the term "rent" is used to refer to the return that comes from land used in these ways, it is called economic rent.

How Does Commercial Rent Differ from Economic Rent?—From what has just been said you will see that there are two kinds of rent: (1) commercial rent and (2) economic rent. Economic rent has just been described and needs no further comment. It is the income derived from the ownership of a natural resource and the price paid for its use.

Commercial rent is the amount paid by one person to another for the temporary use of some durable good which is to be returned to the owner at the end of the specified period of use. When you hire a typewriter for \$2 a month, the price you pay for the use of the machine is commercial rent. You use the typewriter for a month and then return it to the person from whom you hired or rented it. Commercial rent corresponds closely to the popular use of the term.

Why Is Rent Paid?—Why will people pay for the use of land? Of course, one answer is that they gain something by doing so. But why will people pay more for the use of some land than for the use of other land? In an earlier chapter (Chapter V) you learned that all land is not alike; that some of it is more fertile than other land; and that some of it is better situated for certain purposes than other land. It follows that the owner of the better land will receive more for its

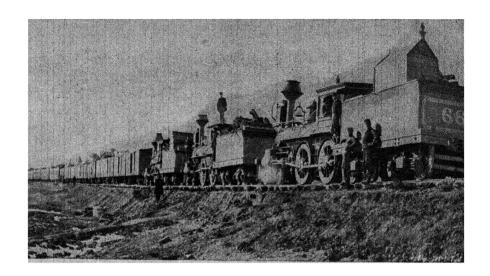


Courtesy of Tennessee Valley Authority

LOW-RENT LAND—This eroded land rents for very little. Poor land makes poor people. In the Tennessee Valley, continued cropping of sloping lands and the use of row crops (corn and tobacco) rather than cover crops (alfalfa or lespedeza) have resulted in the loss of fertile topsoil.

use than the owner of poorer land will receive. Every farmer prefers to cultivate the most fertile land he can obtain because it will mean larger crops and greater returns. When he can find fertile land, he will gladly pay the owner a good price for its use. Thus, one reason why rent is paid is because land differs in quality and location; and the better land must be paid for if it is to be had.

There is another reason why rent is paid. This is because one must pay for the use of natural resources if these resources are to be had at all. No one would willingly pay rent for the use of anything unless he had to. In the days when there was an abundance of public lands, which the government gave to anyone who would cultivate part of it, no one paid for this land. But as the free land became scarcer, it was necessary to pay for it if it was to be had. Land is limited in quantity and cannot be reproduced. Practically all natural resources are in



of Union Pacific Railroad Co.

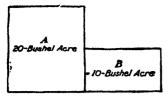
RAILROADS OPEN UP NEW LANDS—When the Union Pacific Railroad was built, it made accessible thousands of acres of rich, fertile land, which now supports a large population. This is the construction train that was used in 1868.

the same class. Thus, anyone who owns a natural resource that is relatively scarce is in a position to demand and to obtain a good price for permitting others to use it. Since natural resources are not all alike, we must find out how they differ and how this difference affects the matter of rent.

Rent of Agricultural Land.—In the case of agricultural land, fertility and location play a very important part in determining what rent will be paid for it. The relative desirability of some pieces of land over others is constantly being affected by movements of population, by new means of transportation, by improvements in methods. of production, and by changes in the demand for goods.

If the population shifts from one locality to another, rents and land values in the second location increase and those in the first location decrease. If a railroad opens up a fertile territory which formerly was not accessible, the new territory gains in rental value, while other land near the same market tends to lose its ability to command rent. Thus land in New England suffered a decline in rental value when railroads were built to connect the Western lands with the Eastern seaboard.

The way in which improvements in methods of production affect rents may be illustrated by the changes that have been brought about



GOOD LAND AND POOR LAND—One acre of fertile land may yield twice as much as one acre of poor land.

through the introduction of the tractor plow and other farm machinery. These machines have greatly increased the demand for land where they can be used to advantage. Furthermore, a general change in the demand for the products of the soil will have important effects upon the value of land. A change on the part of a large number of people from a desire

for wheat products to a desire for corn products will cause a decline in the value of wheatlands and an increase in the value of cornlands.

How Is Economic Rent Determined?—The rent that will be paid for a certain piece of land will depend upon the difference between what this piece of land will produce and what can be obtained from a piece of land that produces just enough to pay expenses. Land that produces just enough to pay for the cost of producing the crop is called no-rent land.

In a small community only the most fertile land will be cultivated. Under these conditions there will be no rent, because all the fertile soil has not been cultivated and more can be had almost for the asking. But as the population of this community increases, more products will be demanded, and it soon becomes necessary to make use of land that is not so fertile. In time this land will all be in use and the poorest land will have to be used also. The least fertile land now becomes norent, or marginal, land. The more fertile land yields rent.

The amount of rent obtained will depend upon the differences in the product obtained from the two pieces of land when equal amounts of capital and labor are spent upon them. For example, if we assume that a certain amount of labor and capital expended on good land will produce a yield of twenty bushels of corn to an acre, while the same effort put into raising corn on marginal land will give us only ten bushels to the acre, then the amount of advantage of the first piece of land over the second is ten bushels. The economic rent of the first piece of land is, therefore, ten bushels per acre. This may be made clearer by means of the diagram above.

Do Diminishing Returns Affect Rent?—You may wonder why anyone ever uses poor land at all. Why not use only good land and cultivate it more intensively, and thus obtain all that will be needed? Would not this supply all that could be needed without using poor

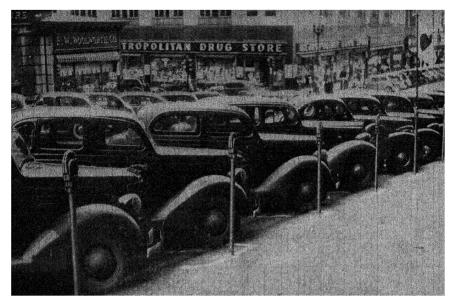
land at all? This may sound like good reasoning. But you will recall that in Chapter V you studied the law of diminishing returns. This law showed that the application of more units of labor and capital on a given piece of agricultural land did not yield a uniform increase in the product. According to this law, if you cultivate a piece of land intensively, you will reach a point where you will receive a less and not a greater increase in the product. So the idea that we can do without using poor land will not hold good.

City Lands Yield Rent.—City land is used for one of two purposes usually: a place upon which to build residences or to build factories and stores. In the case of city land no one is interested in the fertility of the land. Location is the important element. Some locations are better than others for certain purposes. It is not usual to build residences near railroads or harbors because these are worth more for business purposes.

Since location is the most important factor in city lands, the land that has the best location brings the highest rent and vice versa. Merchants have a preference for some locations over others. Thus five-and-ten-cent stores are nearly always located on or near busy corners. The factors that determine the locating of retail stores are the type and size of the crowds that pass certain points during a day. The business lot in the heart of the city enjoys the best location and yields economic rent to its owner.

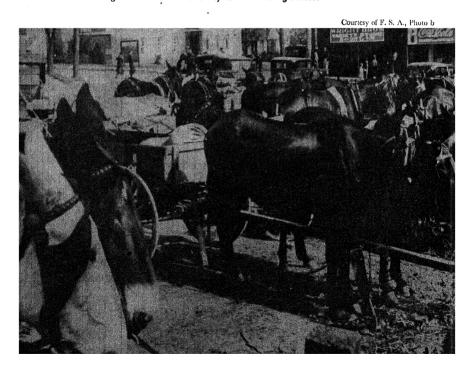
Anything that tends to make a location more desirable will tend to increase the economic rent of that location. Attractive views and nearness of parks add to the value of residence sites; slums, railroad yards, and dumps reduce the residence values and rents. The presence of a good harbor or of water power and transportation, facilities increases the value of land for factories and warehouses.

Retail stores are frequently located near intersecting streets or where there is a great amount of traffic. Sometimes a store on one side of a street will command a higher rent than a store on the opposite side. This is mainly because more people pass on that side of the street than on the other. The popularity of the automobile has caused people to scatter about a community, and this has had an effect on rents in the residential sections as well as in the business districts. General use of the automobile has made it possible for a larger number of people to reach the central locations quickly and cheaply.



Courtesy of F. S. A., Photo by Val

THE AUTOMOBILE VERSUS THE MULE—Above is a street in Omaha, Neb., lined with cars. Compared with the picture below, this shopping district is modern and well developed. Rents are high. Through use of the automobile, the people in surrounding districts can use this city as a marketing center.



Does Rent Enter into Price?—There is a common belief that high rents are the reason for high prices. This is natural when one often hears a merchant say that it is necessary for him to charge high prices because he is obliged to pay high rents. But this is not true. If you will note the location of the five-and-tens in your city, you will see that they are located where the rents are very high. Yet you know that their prices are the lowest. Again, a large department store located on an expensive corner does not charge any higher prices for its goods than a store less favorably located. It is not high rents that make high prices, but high prices that make high rents. The rent of agricultural land is high because the price of farm products is high and not the reverse.

What Is Unearned Increment?—The person who purchases several acres of land on the outskirts of a growing city, and does nothing to them except to hold them and to pay taxes, may make a lot of money when the city grows and his land is wanted for new homes. The land has increased in value because the city has grown in population and needs more land to house its inhabitants. But the owner of the land has contributed nothing whatever to the increase in value. This increase in value of land due to society, and not earned by the owner, is called *unearned increment* of land.

Not only may land increase in value owing to social forces over which the owner has no control, but it may also actually decrease in value for the same reasons. For example, a different class of people may move into a neighborhood and cause rents to fall; or the zoning ordinances of the city may be changed permitting the building of offices or factories or warehouses, which tend to make the section undesirable for residences. This may mean a loss to owners of property, and they are powerless to do anything about it.

Summary.—The agencies that make efficient production possible expect to obtain a share of the proceeds from the sale of these products, which is known as the industrial, or national, income. The share of this national income that goes to the owner of natural resources is called economic rent. It differs from commercial rent in that the latter is paid for the temporary use of durable goods which man has created. Rent is paid for the use of natural resources because of their scarcity. There is a definite limit to most of the gifts of nature. Rent is also paid for land because some of it is more productive than other land. In the case of agricultural land, fertility and location are important

factors in determining the amount of rent that will be paid. In the case of city land, it is location that counts most. Other factors that affect the amount of economic rent are changes in population, development of new means of transportation, changes in the demand for goods, and improvements in the means of production.

It sometimes happens that individuals or groups receive rent from land which they do not work at all and which they do not allow others to work. They simply hold the land idle until its value has been increased by the growth of the community or other acts of society as a whole. Then they sell the land at much more than they paid for it. This gain is called unearned increment or increase, but it is a form of economic rent. It also happens that people suffer a loss in rent because of changes made by society or government. This is called an unearned decrement or loss.

#### Questions to Test Your Knowledge

- 1. What is meant by the national income?
- 2. Define distribution.
- 3. Who share in the national income?
- 4. What names are given to the several shares?
- 5. How do economists define rent?
- 6. Distinguish between economic rent and commercial rent.
- 7. Give two reasons why rent is paid.
- 8. What determines the amount of rent that will be paid for agricultural land?
- 9. What is the relation between rent and high prices?
- 10. What are the factors that affect the rent of city lands?
- 11. Explain the unearned increment in the value of land.

#### Questions for Discussion and Application

- 1. Discuss the problem of the distribution of the national income.
- 2. Why are the costs of production not the same for every piece of land?
- 3. Give as many arguments as you can to justify the payment of rent.
- 4. "If all land were equally fertile and equally distant from markets, there would be no question of rent." Discuss this statement.
- 5. What is the determining factor in the location of a retail grocery store? List other factors that might be considered.

- 6. Show that landowners sometimes suffer an unearned decrease in the value of their land. What are some of the causes for such a decrease in values?
- 7. Discuss the reasons why tenants do not usually make permanent improvements on rented land.

#### Floor Talks and Written Reports

- 1. Unearned increments in large cities.
- 2. Diminishing returns and economic rent.
- 3. Population changes and land rents.

#### Topic for Debate

RESOLVED, That all land should be taxed to the full value of its economic rent.

#### For Further Information

Building America, "Conservation," Vol. II, No. 7; "Our Farmers," Vol. III, No. 2.

Gemmill, P. F., "Fundamentals of Economics," Chaps. XXV, XXVI.

Public Affairs Pamphlets, "Saving Our Soil," No. 14; "Farmers without Land," No. 12.

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# PROBLEM 23

#### Is Rent Related to Retail Prices?

A merchant has been conducting a retail shoe business in a store located on the fringe of the business district of a large city. In his advertising he claims that he can sell goods cheaper than competing merchants nearer the business center because he pays a low rent.

- 1. Why is his rent lower than that of his competitors?
- 2. Does his lower rent permit him to undersell, his competitors?
- 3. Suppose he does get the business of his competitors, how will the economic rent of his site be affected?
- 4. Would his claim of cheap rent continue to be valid?
- 5. If he owns the store site that he uses and advertises that he can undersell his competitors because of this fact, how valid is his advertising?

## Chapter XX

# Wages—Income from Labor

#### Aims of This Chapter:

To define wages.

To distinguish between nominal wages and real wages.

To examine the methods of paying wages.

To learn why wages differ in different groups.

To find out what factors influence the wage rate.

In the preceding chapter you learned that the owner of natural resources, who uses these resources in producing goods, receives a share of the national income called "economic" rent. In this chapter you will learn about another share. This is the share that is earned by those who work; it is called "wages."

What Are Wages?—There will be no difficulty in understanding the term "wages" because it is an expression you have heard and used many times. In economics wages is the price paid for labor of any kind. All those who engage in work, whether it be with the hands or with the mind, whether it be the most menial chore or the most important task, from the unskilled worker to the highest paid executive of a large corporation, receive wages in return for the services they render.

Real Wages Differ from Nominal Wages.—It is customary to measure wages in two ways: (1) in terms of the actual money received and (2) in terms of goods this money will buy. When wages are measured in terms of actual money, they are called nominal wages, when wages are measured in terms of goods, they are called real wages. It is important to remember this distinction because real wages are more significant than nominal wages. An example will prove this.

Suppose that your father receives a salary of \$40 a week. When he receives this amount in his pay envelope each week, it is his nominal wage. When he mentions his income to anyone, he says that he gets



Ewing Galloway

MAKING UP PAY ENVELOPES—Here clerks are filling pay envelopes at the East Pittsburgh plant of the Westinghouse Electric Company. Some of this money will go to those who receive time wages, some to those on piece wages, and some to those on salary.

\$40 a week. This is the usual way of letting people know how much we earn. But this does not tell anyone how well off we are. When your father spends his income for family needs and for other expenses, he discovers some very interesting things about real wages. If the price of goods he usually buys has risen, your father finds that his \$40 do not provide so many things or so much of the same things as before. His real wages have declined, and he is not so well off. But if the price of these goods has dropped, he finds that his \$40 buys more than it did before. His real wages have increased, and he is better off than before. Thus he measures his welfare by his real wages and not by his nominal wages.

How Are Wages Paid?—The distinction between nominal wages and real wages gives us a means of measuring wages. But this does not tell us anything about the methods by which wages are paid. What are these methods?

Time Wages.—Probably more people are paid time wages than any other kind. By time wages is meant the payment made for services performed over certain periods of time, such as an hour, a day, a



Courtesy of Wright Aeronautical Corporation

PUNCHING THE TIME CLOCK—The day's work over, these men who helped to build Cyclone aircraft engines for warplanes at the Paterson, N.J., plant of the Wright Aeronautical Corporation are lined up to "clock out." One man has inserted his time card in the clock which registers the hour he leaves the plant.

month, or a year. In the case of those who work in stores, in offices, or at tasks where there is a certain amount of time not spent in actual work, it is the only fair way. For example, a clerk in a retail store is not busy selling all day long, and it would not be fair to deduct for the time the clerk was idle because there were no customers requiring attention. So it is better to pay the clerk so much per week or month. Likewise, people who are engaged in such work as teaching, bookkeeping, and accounting are paid time wages; we call their pay "salary." Time wages, then, are determined by the unit of time and not by the amount of work done.

Piecework Wages.—Not all workers are engaged in tasks that can be measured by the unit of time. In factories where workers are engaged in making parts of a machine or where the tasks can be measured easily, a different wage method is used. This is known as the "piecework" wage. A garment worker who makes buttonholes only is paid a certain amount for every dozen buttonholes she makes.

This method of payment is supposed to give the worker a special incentive to work harder because the more he does, the higher his wages will be. Thus, the more efficient worker may earn more in this

way than he could if he were receiving time wages; slower workers receive less. However, this method is not popular with all workers. Some workers claim that as soon as they begin to earn high wages, because they have increased their efficiency, the employer either lowers the rate per piece or increases the amount necessary to earn the regular rate. The system of forcing a worker to work faster in order to earn his pay is called "speeding up." This is bitterly resented by workers; and labor unions, as a rule, are opposed to the piecework method of paying wages.

Fees and Commissions.—Some people are engaged in occupations that involve long periods of seeming idleness before results are obtained. Others are engaged in rendering services that cannot be measured by time or by the piecework method. Professional people, such as doctors, dentists, lawyers, and architects charge what are known as fees for their services. An automobile salesman receives his pay in the form of a commission. The same is true of any other salesman or of an agent. A commission is usually a certain percentage of the amount of the sale. Sometimes salesmen are paid a small salary or time wage, plus a commission on all sales.

Extra Wages.—In some industries the employers pay their workers a regular time wage and then, at the end of certain periods, give the employees a proportionate share of the profits. This is known as a bonus. It is an extra wage. Other forms of extra wages are shares of stock in the company or a certain number of days off with pay. The bonus has been called a "bait" to make the workers more loyal or to induce them to turn out more products. Employers sometimes use it to reduce the labor turnover. From the point of view of employers extra wages may be advantageous; but the workers themselves are not always enthusiastic about them. They never refuse the extra wages, but they feel that it would be more satisfactory to them if the employer would increase, their regular wage and pay it to them regularly. In this way they would know what they could count upon whereas they cannot always be sure of a bonus.

Other objections are that such a system tends to tie a worker to his job and weakens his obligations to his union. For this reason labor unions do not like the method.

Do Wages Vary in Different Groups and Occupations?—Some types of workers receive very high salaries while others receive very



Ewing Galloway

SEMISKILLED WORKER—This workman needs no specialized training to perform his job of drilling a valve plate. His age does not perceptibly decrease his efficiency. Many workmen operating simple machines are well advanced in years.

low wages. In between are many groups that receive varying wage rates. These groups may be classified as follows:

Unskilled Manual Workers.—The chief qualification of this group is physical strength. No special training is necessary to perform the tasks, and very little, if any, responsibility is involved. The wages in this class are usually low, and as the workers grow older their wages grow less.

Semiskilled Workers.—In this group are those who operate simple machines that require only tending, and clerical workers who perform routine jobs. The tasks require no special ability, and it is not necessary to undergo a period of training to qualify for the work. The wages are usually slightly higher than those of unskilled

workers. Semiskilled workers do not depend on physical strength, and advancing age does not affect them to the same extent as it does the unskilled workers.

Skilled Workers.—In this group we find those who are skilled in some trade or craft. Natural ability and training are prominent. In this class are found skilled craftsmen, such as mechanics, toolmakers, plumbers, electricians; high-grade clerical workers, such as expert stenographers and bookkeepers; and other types of workers whose duties require the assuming of responsibility and who must have gained experience through long practice. Their wages are higher than either of the two previous classes, and their conditions of work are more pleasant.

Professional Workers and Business Managers.—This group is composed of lawyers, doctors, accountants, dentists, high-grade salesmen, business managers, and those whose success depends on the possession of natural ability and a long course of training. The wages of this class are usually high, and they enjoy a high standard of living.

Outstanding Leaders in the Economic World.—Here we find those who have risen to prominence because of some unusual ability. It includes those who organize and direct our big business units, our leading bankers and financiers, famous movie stars, outstanding musicians and orchestra directors, inventors, and some business managers who are unusually capable. Needless to say that these people command the highest incomes of all the groups.

The above five classes of workers have been called noncompeting. This means that workers in one group do not compete in the labor market with the workers of another group, because the several groups are offering very different services. Moreover, there is little freedom of passing from one group to another. This does not mean that it is impossible to move from one group to a higher group. There is some moving from group to group, but it is slow and somewhat uncertain. The son of a skilled worker may become a professional man or even a highly successful business manager or a banker. But the changes are never rapid enough nor are they on a scale large enough to affect the wages of the other groups.

How Are Wage Rates Determined?—Within each of the groups mentioned above there is competition because there are many types of workers within each group and the numbers able to do the work vary. This means that there are many wage rates in these groups. But, in general, the manner of determining the wage rate is usually the same. This is the manner in which the price of any commodity is determined. In each group the wage rate will be determined at the price that will balance the supply of labor and the demand for that kind of labor.

Although, as a general rule, the wage rate is determined by the market for labor, there are other factors that help to determine the wages paid. We shall mention a few of these.

What the Worker Is Worth to His Employer.—It is the value that labor adds to the product that helps to determine what wages will be paid. This is decided by the employer and not by the worker himself. The employer decides what the worker is worth to him and pays accordingly. All employers have a fair idea of what any kind of labor is worth to them. If they can obtain a good price for the product of labor, they will tend to pay a high wage; if the product ceases to be demanded, the wage rate is reduced or the worker is laid off. No employer will hire a worker who does not produce more than his wages.



Jourtesy of American Telephone & Telegraph Jompany, Photo by Holmes I. Mettee

DANGEROUS CLIMB—Linemen re among those who daily take isks in performing their jobs. This ineman, however, is unconcerned with his precarious position as he ightens a loose messenger strand which is supporting an aerial telephone cable.

Some Jobs Are Irregular.—Earlier you learned that there are some lines of work where employment is irregular. Coal miners are not employed all the year; house painters find little to do during the winter months; and plumbers are not so busy at some seasons of the year as at others. On the other hand, many workers are employed every day in the year except Sundays and holidays. The wage rate of those whose work is irregular tends to be higher than the rate of those whose work is regular within the same group. Whereas \$2.00 an hour may seem a high price to pay a carpenter or a plumber, it should be remembered that over the year their wages will tend to equal those who are employed at a lower rate but for full time.

Some Tasks Are Dangerous.—Some workers take a great deal of risk in

connection with their work. Those who paint high towers, or work in the steel structures of skyscrapers, are flirting with danger every lay. Those who work in lead mills or in factories blowing glass are exposed to deadly gases and frequently shorten their lives because of liseases contracted on their job. To induce enough persons to underake these tasks to supply the demands for the products, high wages nust be paid.

Some Occupations Are More Attractive Than Others.—If we could always choose the type of work we like, many of us would choose attractive tasks. But the most attractive jobs do not always pay the nighest wages. College professors are not relatively highly paid persons, but the work is pleasant, vacations are long, and there is apportunity for research and writing. Professors are willing to accept ess pay because of the attractiveness of the work. On the other hand, o get a person to enter an occupation that does not attract him greatly, a higher wage must be offered.



**Ewing Galloway** 

SPECIALIZED TRAINING—A group of doctors examine an X-ray picture. To practice their highly skilled profession, they must study many years and pass rigid examinations in order to obtain a license.

Probability of Success.—The chances of success in some occupations is greater than in others. But the wage paid at the start in the better occupations is sometimes small. The more difficult it is to succeed, the higher the wages are at the top. This is not always true, but it is quite common. Many are willing to accept low wages at the start because of the chance of getting higher wages later on.

Training and Education.—Some tasks require a long period of specialized education and training before the person is ready to begin his life work. This is true of doctors and lawyers and many others in professional lines. These persons expect to be paid well when they succeed; and this is usually what happens.

Summary.—Wages is the term used to apply to the price paid for labor of any kind. It includes wages paid by the hour, day, or month; it also includes salaries of clerks, managers, and teachers; commissions paid to salesmen and agents; fees paid to professional people; and extra wages paid in the form of bonuses, paid vacations, etc.

A distinction should be made between the actual money wages, called nominal wages, and the commodities that can be purchased with this money. The amount of goods that can be purchased with

the money wages is called real wages. Real wages are important because they measure how well off a worker really is.

The wage rate is determined to a large extent by the demand for labor and the supply available to satisfy the demand. But there are other factors that influence the wage rate. Wages differ in different groups and occupations depending upon the amount of skill and training needed and the amount of responsibility involved. While these groups are noncompeting among one another, there is competition within each group. Again, the rate of wages is affected by the regularity or irregularity of employment, the productivity of labor, the danger and risk of the occupation, the attractiveness of it, and the probability of success in the occupation.

#### Questions to Test Your Knowledge

- 1. Give a definition of wages.
- 2. Distinguish the two ways by which wages are measured.
- 3. Why are real wages more important than nominal wages?
- 4. List the methods used in paying wages.
- 5. Distinguish between fees and commissions.
- 6. Classify the wage groups stating what each group includes.
- 7. How are wages in general determined?
- 8. Name several other factors that influence the wage rate.
- 9. How do time wages differ from piece wages?
- 10. Why are wages different in different groups?

#### Questions for Discussion and Application

- 1. What is the significance of the expression "wages is a price"?
- 2. Why is the attitude of labor unions unfriendly to the payment of extra wages? Do workers themselves approve of this method of paying wages? Why do employers use the method?
- 3. In the final analysis, what determines how much the employer is willing to pay for labor? Has the growth in strength of collective bargaining made any difference in the matter of wage payments? Discuss.
- 4. What reasons can you give for the fact that the most disagreeable work is usually paid less well than agreeable work?
- 5. Why do not more people in the low-wage groups enter the higher wage groups and thus add to their incomes? Give several reasons.

- 6. "Union activity can have no effect on the price paid for labor, since wages are fixed at the point where the demand for labor and the supply of labor are in equilibrium." Criticize this statement.
- 7. It is sometimes assumed that the amount of wages paid to labor can be increased only at the expense of the other sharers in distribution. In what other ways can real wages be increased?

#### Floor Talks and Written Reports

- 1. Efficiency and wages.
- 2. Labor unions and wage rates.
- 3. Standard of living and wages.

#### Topic for Debate

RESOLVED, That wage rates in the different labor groups should be fixed by Federal law.

#### For Further Information

Building America, "Labor" Vol. 3, No. 3.

Douglas, P. H., "Wages and the Family."

Gemmill, P. F., "Fundamentals of Economics," Chap. 27.

Public Affairs Pamphlets, "Income and Economic Progress," No. 1; "Workers and Bosses are Human," No. 75; "Freedom from Want: World Goal," No. 80.

#### PROBLEM 24

#### Labor Changes among Groups

Each year as graduation approaches, pupils in the senior class are asked to state what occupation they propose to enter and these choices are printed in the yearbook. As a matter of economic interest, let each student in this class state the occupation he or she expects to make his or her life work.

- 1. How many expect to compete directly with their respective fathers?
- 2. How many expect to enter other occupations in the same noncompeting group?
- 3. How many expect to cross over into a group not occupied by their respective fathers?
- 4. What does this study show regarding the ease with which lines between noncompeting groups can be crossed?

## Chapter XXI

# Interest-Income from Capital

#### Aims of This Chapter:

To define interest.

To find out why people will pay interest.

To discover why interest rates vary.

To learn how current interest rate is determined.

You have now discussed the shares that go to two of the primary factors of production. The share that goes to the owner of natural resources is called "economic" rent; while the share that goes to labor is "wages." You will now learn about the share that goes to the owner of capital. The name given to this share is "interest."

What Is Interest?—When the term "interest" is mentioned, most people are likely to think of it as money paid for the use of money, as that is what they were taught in school years ago. But let us see if this is really what interest is. When a businessman goes to a bank to borrow for the purpose of buying a new machine for his factory, what is it he really wants? Does he want the money itself, or does he want the machine? Of course, it is the machine that he wants, for the machine will help him to make more profits in his business. Although the banker lends him a certain amount of money, it is actually only a credit item that enables the businessman to purchase the machine he wants. He has borrowed the means to obtain the capital goods he wants. When he pays back the loan plus the interest, he has really paid interest for the use of capital goods. Interest may be defined as the price paid for the use of capital goods.

Early Notions about Interest.—Ideas about interest have undergone quite a change as time has passed. The ancient Greeks believed that money could not earn more money, and so they could not justify the charging of interest for the use of money. For a similar reason the early church forbade its members to charge interest when they lent

money. Most of the loans in ancient times and even during the Middle Ages were made for personal use and were unproductive. Those who borrowed wanted money for goods to satisfy personal wants or to repay money that had already been spent for such goods. Charging interest on money lent for such a purpose was considered a sin; it was forbidden. Naturally, all people were not members of the Christian church and so were not forbidden to charge interest on loans. Also Christians needed money for other purposes than for personal wants and began the practice of going to those who would lend it to them. Gradually the ideas about the charging of interest changed until today hardly anyone would think of lending money without charging something for the service.

Why Does the Lender Insist upon Interest?—The person who lends funds to another gives up what he has accumulated in return for a promise that it will

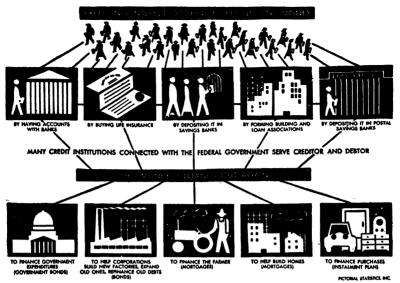


EARLY MONEY LENDERS-These shrewd fellows are checking up their accounts after a day of lending and exchanging money. They seem satisfied. Observe the simple surroundings, so different from a modern bank.

be paid back sometime in the future. The lender does not have the use of his money again until such time as the loan is repaid. He has deprived himself of the opportunity to spend this money himself at the present time and must wait a certain length of time before he can spend it.

An example will make this clearer. Suppose you have succeeded in saving \$500 over a period of years in order to take a vacation trip to California. But before you start on the trip, you are persuaded to lend it to another person who wishes to buy a machine he needs. He wishes to borrow the money for two years. You have made great plans for this trip and were almost ready to start. Why did you deprive yourself of the pleasure now? It was because the borrower agreed to pay you something each year for the use of the money. You went without your trip because you figured that the reward for doing so was worth the present sacrifice of the money.

This is another way of saying that in order to persuade you to



Pictorial Statistics, Inc., from Stewart, Cooperatives in the United States, Public Affairs Committee, Inc., New York

WAYS OF LENDING MONEY—This chart shows how people really are lending their money when they deposit it in banks or buy insurance. These institutions in turn lend the money to all sorts of industries, to the government, and to individuals.

give up the present enjoyment of your money, you must be rewarded for doing so. This is because present enjoyment of money is valued more highly than future enjoyment. The inducement or reward for your action is called "interest." This is sometimes called the abstinence theory of interest.

Why Are Borrowers Willing to Pay Interest?—It is because the borrower knows that he can make more money with the funds he borrows than he has to pay for the use of the funds. Let us illustrate this. A merchant borrows the sum of \$1,000 to purchase a delivery truck. He agrees to pay 5 per cent a year for the loan. By having the truck he can increase his business through the better service he is then able to render his customers. He figures that the truck will add more than \$50 a year to his profits, and so he is willing to pay this amount each year for the use of the \$1,000. In other words, he can make a profit from the use of the capital borrowed. This is sometimes called the productive theory of interest.

Why Do Interest Rates Vary?—We have explained why lenders demand interest and why borrowers are willing to pay interest. Nothing has been said about the *rate* of interest that has to be paid. Not

all those who wish to borrow are able to obtain the funds at the same rate. The rates of interest on loans vary from time to time, from one locality to another, and for different types of loans. Let us see what the reasons are for these variations in interest rates.

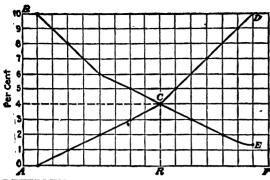
Differences in Localities.—The rate of interest charged for loans varies with the locality. For example, nearly every state in the United States has a rate that differs from that in other states. Whereas 6 per cent is more common than any other, some are lower, and some are higher; still others have no legal rate at all. The rate charged in a small or undeveloped section would tend to be higher than in a large or well-established section.

Differences in Industries.—If the industry is large, well established, and has a reputation for meeting its obligations promptly, it will be able to borrow funds at a lower rate of interest than a small industry that is comparatively new and has not yet established a good credit standing. Moreover, those industries which are managed by experienced men who are well known will tend to pay less for a loan than an industry managed by inexperienced and less well-known men.

Amount of Risk Involved.—Whenever money is loaned, the lender takes a certain amount of risk. Although no loan can be said to be absolutely sure of being repaid, it is safe to say that the promises of the national government come as near being sure as anything can be. All other loans carry varying degrees of risk. The greater the risk one takes in lending money, the higher the rate of interest he will expect to get. The reason why it costs more to obtain a personal loan is because such loans are considered greater risks than commercial loans.

The Element of Time.—The rate of interest varies with the length of time for which the loan is made. Usually it costs less to borrow money for a short period of time than for a longer period. This is partly because a short-term loan can be turned into cash more quickly than a long-term loan. Moreover, the person who lends money for a long period is obliged to wait longer to get his money back and so demands a higher reward for lending it.

Use Made of the Loan.—How the borrowed funds are to be used makes a difference in what they will cost the borrower. Banks and other lenders do not like to take chances in lending money to a busi-



DETERMINATION OF CURRENT INTEREST RATE—In the graph above, AF represents the available funds to be loaned; AB, the rate payable for the various loans; C, the current rate.

ness that is engaged in making something that is a fad and may soon cease to be demanded. They prefer to lend to stable businesses that manufacture articles of general use. So, as a general rule, higher rates are charged for loans for purposes of personal consumption than for productive purposes.

How Is Current Interest Rate Determined?—Interest is the price paid for the use of capital goods. Since interest is a price, the current price that will be charged for the use of capital goods is determined in the same way that the market price for other goods is determined. This was explained in Chapter X.

The capital market is made up of two groups: (1) those who wish to borrow funds and (2) those who have funds to lend. Those who wish to borrow funds know how much they can afford to pay for the use of capital, while those who have funds to lend know the least they will accept for the use of their capital. Among the borrowers are some who can afford to pay more than others for the use of capital; and so there is competition for the available funds. On the other hand, there are also lenders who can afford to accept less for their funds than others; and there is, likewise, competition among them. Those who have a low rate in mind must offer a rate high enough to obtain the funds they want, while those who are willing to pay a high rate may be able to obtain funds at a lower rate. Likewise, those who are willing to lend only at a high rate may not be able to lend at all, while those who are willing to lend at a low rate may be able to get a higher rate than they expected. As these groups compete among themselves, an interest rate will finally be arrived at that will make it possible to satisfy the greatest number of borrowers and the greatest number of lenders.

The process of arriving at the current interest rate may be illustrated by the figure above.

In the figure, the line AF represents the funds that are available

for loans, and the line AB represents the rate of interest demanded for the various amounts to be lent. The point C represents the current rate, or the point where the demand for funds and the supply of funds are equal. CR is the current rate, and AR is the amount of capital that will be lent at the rate CR. The curve AC shows the amount actually lent, while the curve CD shows the amount that might have been lent had the rate been higher. The curve BC designates the amount actually borrowed, while CE is the amount that would have been borrowed had the rate been lower.

What Is Usury?—In Biblical times the word "usury" was employed in much the same sense that we use the word "interest" today. As times have changed, so has the meaning of the word "usury" changed. Today it generally conveys the idea of excessive interest rate. Most of our states have a legal maximum above which a lender cannot lawfully fix the interest rate. In many states, however, the laws are not enforced. In some other states unscrupulous lenders find ways of evading the laws by charging a "bonus" in addition to the regular interest rate. Often the extra charges are concealed in what are called "service" or "carrying" charges or "investigation" fees.

What Are Small-loan Laws?—Because there has been so little responsibility in enforcing the usury laws and because it was found that thousands of working people were borrowing small sums of money at exorbitant rates of interest, many states have passed what are called "small-loan laws." The purpose of these laws is twofold: (1) to enable the borrower of small sums, usually \$300 or less, to obtain money from legitimate sources at rates and terms within their means to pay, and (2) to fix the legal rate on such loans at a figure high enough to induce responsible agencies to enter the field with a chance of reasonable profit. The rates vary in different states, but in general they are about 2 to  $3\frac{1}{2}$  per cent a month on unpaid balances. Although these rates seem high if compared with rates on commercial loans, they are much lower than the rates charged by illegal lenders and those who try to evade the laws.

Summary.—The price that is paid for the use of capital goods is called interest. It differs from economic rent in that the latter is paid for the use of natural resources, which are limited and not reproducible, while interest is paid for the use of capital goods, which are not limited and are reproducible. In the early days it was considered a

sin to accept interest, for most of the loans in those days were consumption loans and not productive. Today, interest is charged on all kinds of loans, and no one considers it a sin.

Those who lend funds demand interest because they value present wealth higher than future wealth and must be paid for giving up the use of their wealth now. Those who borrow funds are willing to pay interest because they can make a profit by doing so.

Not all who wish to borrow are able to do so at the same rate of interest. The rate charged depends upon several conditions. Rates vary in different localities depending upon how well developed the industries in those sections are and how much wealth exists in those sections. Other reasons for a variation in rates are the differences in industries, the amount of risk involved in the loan, the length of time the loan is to run, and the use to be made of the loans. In determining the current rate of interest, the same factors of demand and supply are present that are effective in determining the market price of any commodity.

Sometimes an unreasonable rate of interest is charged for a loan. If there is a legal rate in existence, any rate above this is considered illegal. The name often given to an illegal rate of interest is usury. Usury laws are not easy to enforce and as a rule have been ineffective. To overcome the ineffectiveness of usury laws and to protect the borrower of small sums of money for personal needs, many states have passed small-loan laws which are intended to make it possible for borrowers of sums up to \$300 to obtain what they need from legal lenders at rates that are far below what they would pay to illegal lenders.

#### Questions to Test Your Knowledge

- 1. How is interest defined?
- 2. Explain the attitude of ancient peoples toward interest.
- 3. Why do people lend money?
- 4. Why do they expect a reward for lending their money?
- 5. Why are borrowers willing to pay interest?
- 6. List the factors that influence the interest rate.
- 7. Explain how the current interest rate is determined.
- 8. What do you understand by usury?

- 9. What are the two purposes of small loan laws?
- 10. What type of loan is affected by small-loan laws?

#### Questions for Discussion and Application

- 1. Explain why there should be any difference in the interest rates between any two sections of the country. Use your own state and some other state as examples.
- 2. Show the relationship that exists between the payment of interest and the accumulation of and use of capital.
- Discuss the possible effectiveness of laws that attempt to regulate the interest rate.
- 4. "Interest is paid for the use of capital goods and not for the money itself." Explain this statement. Use examples.
- 5. It is said that most of the funds borrowed by consumers and producers is lent by banks which set their own interest rates. Does this mean that borrowers have nothing to say about the rates they shall pay for funds they need? Discuss.
- 6. It is claimed that loans for personal uses are a greater risk than loans for commercial purposes. Is this always true? Is there any connection between this claim and the rates that have been set for small loans to consumers? Can you think of any other reasons for small-loan laws?

#### Floor Talks and Written Reports

- 1. Early ideas about interest.
- 2. Small-loan laws.
- 3. Relationship between savings and capital.
- 4. Why people save.

#### Topic for Debate

RESOLVED, That interest rates should be uniform throughout the United States.

#### For Further Information

Building America, "Banking," Vol. VI, No. 3.

Deibler, F. S., "Principles of Economics," Chap. XX.

Foster, L. R., "Small Loans Laws of the United States."

Gemmill, P. F., "Fundamentals of Economics," Chap. 28.

Public Affairs Pamphlets, "Credit for Consumers," No. 5; "Loan Sharks and Their Victims," No. 39.

#### PROBLEM 25

#### What Is the Interest Rate?

From the set of figures given in the following table, determine the current interest rate that will satisfy the greatest number of lenders and borrowers. Illustrate this by means of a graph.

Amount that will be borrowed at the different rates	Ratc charged, per cent	Amount that will be lent at the different rates
\$300,000,000	7	\$1,000,000,000
400,000,000	6	800,000,000
500,000,000	5	700,000,000
600,000,000	4	600,000,000
700,000,000	3	400,000,000
800,000,000	2	200,000,000

#### PROBLEM 26

#### Consumer Loans

In practically every family there comes a time when a small sum of ready money is needed to pay a hospital bill, the expenses of a long illness, repairs in the home, or to save money by paying cash. Most families find that they cannot save enough to meet any of these needs and they are unable to obtain credit at the commercial bank. They cannot afford to pay loan sharks nor do they wish to deal with them. In many states, laws have been passed that permit the borrowing of sums up to \$300 from legitimate sources and at a reasonable rate of interest considering the risk. Although the price is relatively high, the need for ready cash can be met at a lower price than obtained before these small-loan laws were passed.

- 1. Suppose a family needs \$250 to pay hospital and doctor's bills. Arrangements are made with a personal finance company to borrow the sum on the following terms: The money is to be repaid in monthly installments of \$20 each, with interest at the rate of 2 per cent per month on unpaid balances. No other charges are made.
- 2. How much was paid in interest?
- 3. What rate would this be on the original loan?
- 4. Do you think this was too high a price to pay for the loan? Explain.

## Chapter XXII

# Profits—Income from Business Enterprise

#### Aims of This Chapter:

To learn the nature of profits.

To examine the risks of business.

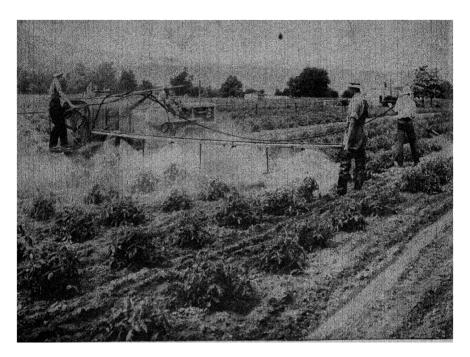
To consider the kinds of profits.

To discuss the regulation of profits.

Thus far we have been interested in learning about the shares of the national income known as "rent," "wages," and "interest." These shares go to natural resources, wage earners, and capitalists, respectively. There is another factor in the productive enterprise who is entitled to his share. He is the businessman or enterpriser. His share is called "profits." In this chapter we shall learn something about profits.

What Are Profits?—As you study the subject of profits, you will be impressed by the fact that they are different from the other shares that you have studied. The other shares are paid out early in the process of production, and it is only after all other shares have been paid that the businessman gets anything for himself. Whatever remains after these expenses have been paid is profit. Profits are the share that the businessman receives because of the risks he has taken and because of his superior ability as a manager.

What Risks Do Businessmen Assume?—We have said that profits are received because of risks that businessmen undertake. What are some of these risks? Everyone knows that there are risks in any line of business. There is the danger that the business may fail and all the capital be lost; there may be strikes and other labor troubles involving expense and losses; a serious depression may occur just as the business is getting under way. Different types of business



Courtes: or Carcipinar Litacior Co.

FARMERS' RISK—Farmers war continuously with insect pests threatening their crops. Here a diesel tractor, with spray rig attached, is being used to spray tomatoes.

are subject to special risks. Thus, farmers are constantly fighting droughts, frosts, floods, pests, and blights. There may be a bumper crop one year and low prices; another year may bring small crops and high prices but heavy expenses. The manufacturer has many things to trouble him. Prices may drop so low that it becomes almost impossible to carry on the business with any degree of success. Fashions may change. Consumer demands may undergo sudden changes, causing a loss or a gain as the case may be. The retailer may lay in a large stock of certain goods which he thinks people will want only to find that the goods are not wanted. Or he may be cautious and stock goods in small quantities only to find that the demand is greater than he anticipated. All these risks, and many more, must be undertaken by anyone managing a business. The ability of a businessman to foresee and meet these risks has much to do with whether he makes profits or suffers losses.

All Businessmen Are Not Alike.—The fact that some businessmen make a large profit while others make little or no profits indicates that there are differences in the abilities of those who engage in business. For convenience we may divide businessmen into three classes.

In the first class will be found those who have exceptional ability as managers and financiers. They possess a keen sense of business analysis, are not afraid to take chances, and boldly promote new enterprises.

The second class is made up of those who have more than average ability. They may not promote and manage large enterprises, but they are highly successful in smaller industries, in hotels, and large department stores. This class is made up of a larger number than the first class and are the types most familiar to you in your community.

The third class contains by far the largest number of those who engage in business. These are men and women of average ability and judgment. They conduct most of the retail trade of their communities or engage in such lines of work as trucking, market gardening, or contracting. Many of them probably do not earn more than they could earn if they worked for someone else, but they like the feeling of independence and of being their own bosses. It is among these men and women that most of the business failures occur, owing either to lack of capital or insufficient business judgment to succeed.

There Are Several Kinds of Profits.—In any discussion of profits it is necessary to keep in mind the different types. Moreover, these types should be carefully distinguished from each other. There are gross profits, net or pure profits, monopoly profits, and competitive profits.

Gross Profits.—These are really not profits at all because they include all the gains made by the businessman in the conduct of his business. They are the total gains before any other items have been deducted. Usually under gross profits are included interest on capital investment or borrowed funds, rent for the buildings used, wages paid to workers, insurance paid on buildings and stock, and the item that is commonly called "profits."

Net or Pure Profits.—This is the sum that remains after all the expenses of the business have been paid. Net profits are the reward for the risk the businessman takes and for the services he renders. All businessmen assume risks, but not all of them receive net profits. Some, in fact, receive just enough to cover all necessary expenses other than profits. That is, they just break even.

This so-called "net" profit is called a "differential"; that is, it is the difference between what an efficient and able manager makes, owing to his superior business ability, over that of a less efficient manager. Some look upon it as a personal gain, a surplus which is desired by all businessmen. Others claim that it measures the risk of the venture. Profits in one year are offset by losses in another year.

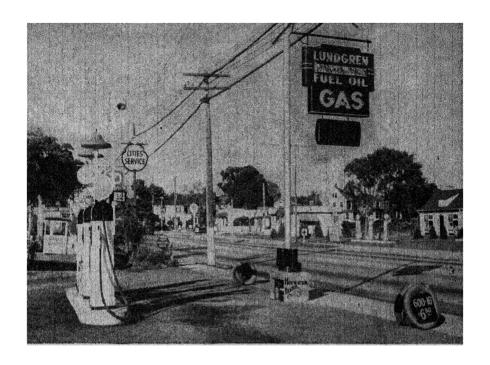
Monopoly Profits.—The monopolist sets his price at the point that will tend to bring him the greatest net profit. This means that monopoly profits are more or less fixed. They are due to some advantage obtained because of the exclusive control of some economic commodity or service.

Competitive Profits.—These are the kind usually meant when we speak of profits. They are profits made under our competitive system of business. They may be due to several causes. Commonly they are considered as due to superior management, wise judgment in buying, the creation of good will, or to some fortunate circumstance. Competitive profits are not at all fixed as are monopoly profits. They may be the result of temporary circumstances that favor one producer or type of producer, while monopoly profits are the result of some special power or privilege.

What Are the Characteristics of Profits?—At the beginning of this chapter it was stated that profits are different from the other shares of the national income. Let us see what these differences are.

Profits Are a Leftover.—We have said that the wise businessman must first meet all the obligations he has assumed toward the other factors of production before he can truly claim any part of the income for himself. He must pay wages to his employees, salaries to his office staff, rent for buildings, interest on capital and borrowings, insurance against risks, money for raw materials, and taxes. If there is anything left after these have been paid, he may claim profits. That is why it is said that profits are a leftover. They exist only if there is something left after all expenses of the business have been met.

Profits Are a Reward for Risks Undertaken.—Wages are not considered a reward for risk because the laborer does not assume any of the risks of the enterprise. He receives his wages when he works and leaves to the owner the worries of management. The employer, on the other hand, assumes many risks when he undertakes to carry on a business of his own. If he is successful in meeting these risks, he is rewarded with a profit. If he is not wise enough or efficient enough to meet the



Keystone View Co.

COMPETITION—GOOD OR BAD?—These five filling stations are engaged in keen competition for the business of passing autoists. What are the chances of all of them making a good living? As more stations engage in the business, what becomes of profits?

risks successfully, he may suffer a loss or just break even. In either case there are no real profits. This reward for risks successfully undertaken is sometimes called *earned income*.

Competition Tends to Eliminate Profits.—This may sound strange to you, but a few words of explanation will make clear what is meant. It seems to be an American characteristic that when a business is successful and making money, others have a keen desire to enter that business and to get some of the returns. The more people that enter the particular business, the less is the chance of all of them making profits. In fact, competition may become so keen that none of them is able to make any money. This has been well illustrated by the large number of gasoline filling stations found in every city and town of any size. In one city of average size there are twenty-two filling stations within a mile along the main artery leading out of the city. It is not strange that the possible profits of all these stations have been reduced by the competition set up. Thus we may say that competition has a tendency to reduce profits to the vanishing point.

Do Profits Enter into Prices?—It is very commonly thought that high profits make high prices. But a little thought will convince you that this is not always true. If you will recall what was said about the relationship between high rent and high prices in Chapter XIX, you will be able to make the same test here. There you learned that high rent did not make high prices but that high prices made high rent. The same is true regarding profits and prices. It is high prices that make high profits, not high profits that make high prices.

As a rule, the price of a commodity is set by what it costs the least efficient producer to make the article, assuming that his article is needed to satisfy the wants of consumers. His price must be met, but he receives no profit since he merely breaks even. But his competitors who are able to produce goods at a lower cost, receive the same price and thus make a profit. When you recall that for many years Henry Ford produced an automobile that was lower in price than any other car and that in spite of this low price he made huge profits, you will see that high profits do not necessarily make high prices.

Should Profits Be Regulated?—The question of profits has been discussed from time to time, and there has grown up a feeling among some groups that they should be eliminated entirely or should at least be regulated by the government. Some feel that it is not good for society to have small groups earning huge profits while many other groups are struggling for a living. Socialists who are opposed to the capitalistic system would do away with profits altogether; they constitute a small but an extreme group. There is another group which would permit profits to exist if made in competitive production but which would eliminate so-called "speculative" profits. Something has been done in this line through the measures that regulate the buying and selling of stocks and of staple commodities. This matter will be discussed later on in this text. Finally, there is a group who object to monopoly profits and would have them regulated or forbidden entirely; they would permit competitive profits.

The influence of these groups has produced a general opposition to large profits, which has been expressed in various forms of legislation of a regulatory character. Thus, the profits of public utilities are regulated by law.

Regulation by government has taken different forms at various times. For example, the government has controlled the rates that railroads may charge and has set up several bureaus to control the prices of commodities, securities, and services. The National Industrial Recovery Act urged the raising of prices in order to encourage industry to employ more people. But, at the same time, it appointed an advisory board to see that consumers did not have to pay too high prices for the goods they wished to buy. During periods of war and of preparation for war, attempts are made to prevent industries from making huge profits and from charging high prices. During the Second World War an attempt was made to take the profits out of war through higher income taxes and especially through excess-profits taxes. An effort was also made to control price increases through the Office of Price Administration (OPA).

The problem of regulating profits in the interests of businessmen who assume risks and the consumers who must buy the goods is a complicated and delicate one. The capitalistic system favors profits. Private industry finds it difficult to obtain funds for expansion and production if it cannot promise profits. Profits in industry make possible larger taxes for governmental purposes. It is hard to know just what to do and the problem is far from solved.

Summary.—The main purpose of anyone who undertakes a business is to earn a profit. But soon after the business is organized and operating, it is found that profits are very uncertain things. Some make profits and many do not. Although wages are earned and must be paid and although taxes are demanded by government and cannot be avoided, there can be profits only if there is something left after these and other expenses have been met. All enterprises involve risks which may eliminate profits altogether. Because all businessmen do not have the same ability and personal qualifications for success, many fail to make any profits and soon retire from business.

Profits differ from other shares in many ways. They are a leftover, they represent the reward for the successful assumption of risks, and they tend to grow less under competition. Contrary to general opinion, profits, like rent, do not make high prices. On the contrary, there will usually be more profits if prices are high than if they are low.

Because in the past many industries and individuals have made high profits in one way or another, there has grown up opposition to them. The socialists would abolish them entirely, while others would regulate them in an attempt to keep them reasonable. But this involves much difficulty and the possibility of doing an injustice to industry and to society. It is a serious and delicate problem which has not yet been solved, although the government has made attempts to control profits and to regulate prices, both upward and downward. It will not be easy to do away with profits so long as they are the motive force behind all business enterprises.

#### Questions to Test Your Knowledge

- 1. How do you define profits?
- 2. Show how profits differ from the other shares you have studied.
- 3. List the risks that businessmen assume.
- 4. Name and give examples of different types of businessmen.
- 5. Distinguish between gross profits and pure profits.
- 6. How do monopoly profits differ from competitive profits?
- 7. How does competition affect profits?
- 8. Show that profits do not enter into prices.
- 9. What suggestions have been made to regulate profits?
- 10. Name some of the efforts government has made to regulate profits.

#### Questions for Discussion and Application

- 1. Discuss the reasons why men enter business. Are they always successful? Why do some fail in business?
- 2. Would profits ever disappear because of the excessive competition among businessmen? If not, what would set a minimum limit below which they would not fall?
- 3. What services does a businessman render to society that causes him to say that he is entitled to profits?
- 4. Are differences in profits due more to skill and ability than to chance? Discuss this.
- 5. Criticize the following statement: "Profits are the reward of efficiency in management and for risk taking; exceptional profits, therefore, must be justified, because they are evidences of greater efficiency or of greater risk."
- 6. The whole product of industry is divided into rent, wages, and profits. Should each of these shares always receive the same proportionate part of the product? How will the relative shares be changed, if the product of industry is increased? if it is decreased? What determines the relative size of each share under changing conditions?

#### Floor Talks and Written Reports

- 1. Government regulation of profits.
- 2. Competition and profits.
- 3. Profits in time of war.

#### Topic for Debate

RESOLVED, That production should be for use and not for profits.

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#### PROBLEM 27

#### What Are Profits?

For ten years Arthur Robson held an important position as buyer for a large New York department store. During this time his salary varied, but for the ten years he averaged \$5,000 a year. Robson was thrifty and managed to save \$10,000 which he had invested in government bonds yielding him an annual income of \$350. During the last two years he acted as buyer, he had an income of \$5,000 a year from a store building which he had inherited from a relative, and which was in a popular section of the city.

Becoming tired of working for someone else and seeing others make profits from the goods he bought for them, he decided to go into business for himself. He resigned his position as buyer, sold his government bonds, and requested his tenant to vacate the store building. With the money received from the sale of bonds he laid in a stock of goods. To obtain his store equipment he had to borrow \$5,000 from a bank at 5 per cent interest. He also hired a man to help him and paid him \$2,000 a year. He managed the store himself and did his own buying. At the end of five years he was curious to learn whether he was better or worse off than when he had worked for a salary. He discovered that his total income for five years had exceeded his total outlay by an amount that averaged \$15,000 a year.

- 1. What was his total annual income before he entered business for himself?
- 2. How much of the \$15,000 average annual income from the store would have to be paid out as expenses? (Consider taxes as \$400 a year and insurance as \$100 a year.)
- 3. How much did this leave him as pure profits?
- 4. Would you advise Robson to stay in business or sell out? Give your reasons.
- 5. What would be your answer to question 4 if the average annual income from the store had been \$10,000 instead of \$15,000? Why?

## Chapter XXIII

# Insuring Against Risks

#### Aims of This Chapter:

To learn that risks exist everywhere.

To define insurance.

To examine several kinds of insurance.

Up to this point in our discussion of business and its conduct, you must have realized that every factor that has a part in the production of goods is subject to some kind of risk. It will now be our task to learn what these risks are and to discuss some of the ways by which they may be lessened through precautions and protected through insurance.

All Agencies of Production Are Menaced by Risks.—The owner of a natural resource runs many risks. Nature is not always subject to the control of man, nor can he always foresee what is to happen. There may be droughts, floods, hurricanes, tornadoes, pests, dust storms, frosts, or some other misfortune that will cause serious loss. The wage earner is not entirely free from risks while he is at work. He may suffer an accident caused by a defect in machinery; he may lose time because of illness; or he may even lose his life. The capitalist who invests his money in an enterprise or lends it to another may suffer loss because of economic conditions that he cannot control or because the person to whom he lends money defaults in his payments. The businessman is subject to many risks too. Changes may occur in the costs of production, new processes may be introduced, and machinery becomes out of date. Since production is now carried on in anticipation of demands, changes in the demands of consumers may mean the scrapping of machinery or the loss on goods already produced but not now wanted. All these conditions may mean the failure of business or at least a reduction in profits.

Thus all factors are subject to many risks. Unless something is

done to reduce the risks wherever possible or to compensate in some way for losses, production might stop and all the factors might be reduced to ruin. But ways have been found to guard against many of these risks, and it will be the business of this chapter to examine some of the means that have been devised. Our interest here is chiefly in life and property insurance. Social insurance will be discussed in a later chapter (Chapter XXXIII).

Early Ways of Reducing Risks.—Risk is usually defined as the chance of loss. Chance of loss has been present ever since there have been human beings on the earth. The risks of primitive man were mostly personal, since he did not have much of an investment in what we call property. As civilization has developed, there has been created an enormous amount of wealth. Moreover, rights of property have been established, and individuals have increased the kind and amount of their property. As an individual's property increases, his chances of loss become greater. In order to guard against losses to his property and his life, man has adopted various measures.

It is not necessary to speak in detail of the various ways man has adopted to protect himself against loss. We all know that he put locks on doors, put his valuables away in strong boxes and in vaults, and hired others to stand guard over his property. All these early ways were subject to the control of man and were no stronger than the men who were responsible. It soon became evident that individuals are not able as a rule to assume heavy risks alone. Thus it has come about that individuals have joined with others in sharing risks and in this way have reduced their own burdens. This method of compensating for losses is called "insurance."

What Is Insurance?—Insurance is a method of spreading over a large number of persons a possible financial loss too serious to be conveniently borne by an individual.

Principles Underlying Insurance.—One of the primary principles upon which insurance is based is the spreading of risk over a large number of persons. Each person insured contributes to a fund, from which sums are taken to repay those who suffer a loss. The sum that each insured person pays for protection is called a *premium* and is collected at stipulated intervals by the insurance company. It is collected from a large number of persons year after year, but in the case of property insurance only a few of those who contribute ever

suffer a loss requiring payment. Through premium payments insurance companies are able to accumulate funds that enable them to meet demands made upon them. By the scientific use of statistics and records of losses, insurance companies can accurately measure the risk of any particular occurrence and thus know what to charge as a premium for protection against that risk.

Another basic principle of insurance is that companies that insure property do not accept many risks in any one community but scatter them over a large area. They are thus protected against too serious a loss in case of a disaster such as the hurricane that occurred in 1938.

Most insurance companies are conservative in the risks they assume. They insist that, before a person is permitted to insure property or a life, he must prove that he has an *insurable interest*. This means that the person desiring to buy insurance must be able to prove that he will suffer some financial or other loss if certain things happen to the object or, in the case of life insurance, that the beneficiary will suffer financial loss at the death of the person insured. In this way insurance companies protect the public interest against those who might be dishonest and seek to gain at the expense of the policyholders.

Terms Used in Insurance.—In our discussion of insurance, certain terms will keep coming up and you should know what they mean. The person who buys insurance is known as the *insured*; the insurance company is called the *insurer*. The agreement between the insured and the insurance company is called a *policy*. This contains all the terms under which the insurance is sold. The amount that the insured pays at stated intervals for insurance is a *premium*. This premium may be paid annually, semiannually, quarterly, or monthly. The one who is to receive the insurance money in case property is damaged, or in the case of the death of a person, is called the *beneficiary*. Some insurance companies, usually referred to as *mutual* companies, return to their policyholders the portion of the premium not needed in the light of actual experience. These are called *dividends*.

There Are Several Kinds of Insurance.—Just as there are all kinds of risks in our daily lives and activities, so there are all kinds of companies which will insure all kinds of risks. You will immediately think of fire insurance, life insurance, and automobile insurance. In addition to these there are many other kinds such as health and accident insurance, insurance against damage by floods, hurricanes, wind storms, hailstorms, frosts, droughts, and the like. Then we have



Ewing Galloway

THE INSURANCE POLICY—The young man is a life insurance agent who is handing an "ordinary" policy to the older businessman. This businessman is one of 63,000,000 people who believe they can protect their wives and children from poverty in case they should die before their time.

liability insurance, burglary insurance, and insurance against the default of debtors. Finally, we have what is called "social insurance" covering losses through unemployment, old age, and hospital care. These are treated in Chapter XXXIII.

There is no need to discuss all these kinds of insurance, but we shall examine the more common of those forms which give protection to the various factors of production.

What Is Life Insurance?—Wage earners and other individuals purchase insurance to protect their dependents against loss of income through their death, and themselves against loss of income in old age. This kind of insurance is called "life insurance" and exists in many forms. Usually a person must take a physical examination and provide other evidence that he is a good risk before he can buy a life insurance policy. We shall describe only the three commoner forms of life insurance: term insurance, whole-life, and endowment.

Term Insurance.—This is a type of insurance that gives protection for a limited period, usually, five, ten, or twenty years. It is temporary insurance and is purely for protection. The face value of the policy is payable only if death occurs during the term specified. If the insured is alive at the end of the period specified, he is no longer insured, unless he renews the policy or changes it to a life or endowment policy. Such insurance is good for those who wish to provide funds to pay off



EWING GANOWAY

VARIOUS TYPES OF POLICIES There are many companies which sell life insurance, and cach of these companies sells many kinds. Here are a few kinds of policies.

unpaid debts, to protect a new business while it is being established, or to provide for the education of children. This type of insurance has the lowest premium rate of any type of policy and can be converted into whole life or endowment without another physical examination. The conversion must be made before the term expires. Most term insurance policies have no cash surrender value; but some long-term policies have a cash value and can be used as security for a loan if the lender is willing to accept it as security. All wholelife and endowment policies have cash or loan values which may be helpful in emergencies but which should not otherwise be used.

Whole-life Insurance.—There are two common forms of whole-life insurance:
(1) ordinary, or straight-life, and (2) limited-payment life policies. Ordinary life insurance is probably the commonest form of life insurance sold. It gives protection over a period of years. It is the kind that a person buys who wishes primarily to protect his dependents. The premium rate for this type is the lowest of all kinds of permanent insurance. It pays the face amount of the policy, either in cash or income, to the beneficiary upon the death of the insured. Premiums are usually paid throughout the life of

the insured although, in the case of participating policies, dividends are paid and arrangements may be made by which they may be used to reduce the length of the time one has to pay. Or, they may also be used in several other ways.

Another form of whole-life insurance is the *limited-payment policy*. If a person does not wish to pay premiums all his life, he may purchase a form of whole-life policy which becomes paid up at the end of a

# HISTORY OF 10,000 LIFE INSURANCE POLICY HOLDERS

ALL THE SAME AGE: EACH PURCHASED \$1,000 OF ORDINARY LIFE AT AGE 35;

MORTALITY TABLE USED: AMERICAN MEN, 3% INTEREST; NET ANNUAL PREMIUM \$18.99

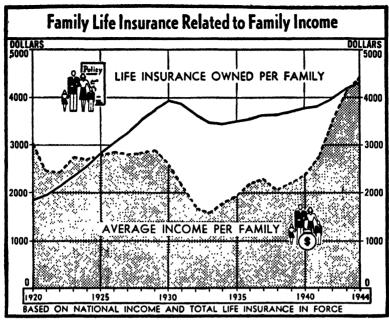
10 YEAR PERIODS	Age 35-44	Age 45-54	Age 55-64	Age 65-74	Age 75-84	Age 85-94	Age95-103
NUMBER LIVING AT BEGINNING OF PERIOD	10,000	9,429 11744111111111	8,400 144111118	6,432 - 4 1111118111	3,440	817	32
TOTAL PREMIUMS PAID DURING PERIOD	\$1,854,126.63	\$1,713,524.67	\$1,445,101.02	\$976,237.92	\$405,569.43	\$62,894.88	\$1,443.24
TOTAL INTEREST EARNED ON INVESTMENTS DURING PERIOD	\$262,022.22	\$715,805.19	\$1,028,793.61)	\$960,972,53	\$486,351.56	\$85,033.66	\$2,123.44
NUMBER OF PERSONS DYING DURING PERIOD	571	1,029	1,968	2,992	2,623	785	32
TOTAL OF DEATH BENEFITS PAID DURING PERIOD	\$.571,000.00	\$1,029,000.00	\$1,968,000.00	\$2,992,000.00	\$2,623,000.00	\$785,000.00	\$32,000.00
FUND AT END OF PERIOD AFTER BENEFIT PAYMENTS	\$1,545,148.85	\$2,945,478.71	\$3,451,373,34	\$2,396,583.79	\$665,504.78	\$28,433.32 **********************************	-0-

Courtesy of Institute of Life Insurance

The chart above illustrates the operation of the life insurance plan for a group of people all the same age. From an examination of this chart, the reader gains a clear picture of the operation of the level premium system.

specified period of years, such as ten, fifteen, twenty, or at a certain age, such as sixty or sixty-five. At the end of the specified period the insured does not have to pay any more premiums but the insurance protection continues in effect until his death. Upon the death of the insured the insurance company will pay the beneficiary the face amount of the policy either in cash or income. This type of policy is excellent for those whose incomes permit larger payments for a short period of years and for those who know that their earnings will be less in later life. The premiums on limited-payment policies are higher than on ordinary life policies but they are paid up in a shorter time.

Endowment Insurance.—This combines insurance with a method for accumulating a fund of money over a definite period of time.



Courtesy of Institute of Life Insurance

As family income increases there is a tendency to purchase more insurance; as the income drops, less is bought.

Endowment policies pay a specified sum to the insured at the end of a specified period if he is still living. If he dies before the end of the period, the face value of the policy or its equivalent in income is paid to the beneficiary. The premium rate is higher than whole-life policies because it must pay the cost of protection and enough more to accumulate a fund with interest to pay the face value at the end of the specified period. The insured has no more actual protection in an endowment policy than he has in a whole-life policy. He pays more for it because he has a life investment as well as death protection. The insured, if alive at the end of the period, may turn it in and receive its maturity value, or he may convert it into an annuity.

Annuities Are Not Life Insurance.—An annuity provides for the payment of money by the insurance company in equal installments over a period of time, usually the remaining lifetime of the person who buys the annuity, who is called the *annuitant*. Annuities are usually bought because the purchaser thinks he may outlive his earning period and so wants to make sure that he will have a steady income during his remaining years. Many persons wish to retire at

a certain age and so buy an annuity that will provide income after this time. The cost of an annuity varies with the age at which it begins to operate and with the amount of income desired.

Annuities are of several kinds. They can be purchased by the payment of a lump sum or by the payment of premiums over a period of years. A straight-life annuity guarantees to pay the income to the annuitant as long as he lives. When he dies, the income ceases. An installment-refund life annuity pays an income for life but in addition guarantees to make payments until the original principal sum has been paid back, should the annuitant die before that time. A cash-refund annuity pays an income for life but in addition provides for the payment in cash of the balance of the original principle, should the annuitant die before he has received this amount in installments.

How to Protect Your Property from Fire.—This is one of the most important types of property insurance. It is purchased by individuals and business firms to protect their buildings and other property from damage caused by fire. The farmer buys it to insure his home and his barns; the manufacturer buys it to protect his factory and machinery; the wholesaler insures his warehouse; the retailer insures his store, fixtures, and stock of goods; private individuals insure their houses and furniture. In all these cases a serious fire may cause great loss or even a failure in business. Fire insurance serves to reduce the possible loss and to aid in restoring buildings and stocks of goods.

Automobile Insurance Is Needed by Every Car Owner.—Both businessmen and private individuals use automobiles. It is claimed that about 90 per cent of all cars are used for some form of business service, either directly in the business or as a means to get workers to their work. Trucks and busses are a common sight on the highways and passenger cars are very numerous. In the case of businessmen whose trucks and busses are operated by employees, the chances of serious accidents causing heavy losses are so great that they insure against them. One accident in which a life is lost may result in such heavy damages that the profits for a long time will disappear.

Not only is there the risk of accidents causing death, but other types of accidents are occurring constantly. Whereas many of these accidents may involve only minor expense, they total a large sum over a year. Automobiles may damage the property of others or be

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damaged themselves. They may catch fire and burn up or be stolen. All these are risks which should be guarded against. There are several kinds of automobile insurance to take care of these different risks.

Personal Liability Insurance.—This is the kind of insurance that protects the owner of a car or truck against loss due to injuring other people in an accident in which his car is involved. The courts are rather severe at times in awarding damages for injuries to others by automobiles. Personal liability insurance reduces the loss to the owner of the car. Although only one or two states make this kind of insurance compulsory, most people who operate cars carry it. It is especially desirable for businessmen who operate delivery trucks.

Property-damage Insurance.—This covers the owner of an automobile against loss when his automobile damages the property of another person or the car of another. Costs for such damage sometimes amount to hundreds of dollars and eat into income unless some form of protection is carried.

Fire and Theft Insurance.—Businessmen have invested large sums of money in their trucks and other cars used in their business. Workingmen also have a large sum at stake when they buy a car. These cars are subject to the risk of being stolen or of being destroyed by a fire. The loss of a truck may mean the loss of several thousand dollars especially if it is one needed daily in business. For a small premium the owner can be protected against these risks.

Guest Coverage Insurance.—On many trucks and delivery cars you have seen the sign "No Riders." This is placed there for a good reason. Whereas it may be a kindness to help someone who is going a long distance and the driver may like company, the chances of injury to the guest while riding in the truck or car are so great that owners do not care to take any chances. So they forbid their drivers to take hitch-hikers or others on their trucks. A person who is injured while riding in a truck or other car may bring a suit for damages which will cause the owner great inconvenience and expense. Guest coverage insurance places upon the insurance company part of the responsibility for accidents to those being carried as a favor and relieves the owner of loss should an accident happen. This type of insurance is inexpensive.

Employees Need Liability Insurance.—Most employers buy liability insurance against accidents to their employees for which they are legally liable and even against accidents in ordinary occupations that are not directly covered by the laws. They do this to protect themselves against possible lawsuits for damages. Thus those contractors who erect bridges, buildings, or factories, and those who paint houses and churches, buy liability insurance to protect them in case any employee suffers injury while at work. Theater owners insure themselves against possible accidents to the patrons of their houses; owners of apartment houses, office buildings, and hotels insure themselves against accidents to those who use their elevators. Even physicians, surgeons, and hospitals may protect themselves against any misfortune to patients for whom they may be held responsible.

Ships and Cargoes Are Insured.—Many businessmen are engaged in shipping goods by water to other parts of the country or to foreign lands. The owners of the ships as well as those whose goods are being transported are assuming risks when they are engaged in handling goods. Ships may be lost or damaged by storms, fires, or collision with other ships or obstructions. Ships are insured under marine insurance policies, and cargoes are insured to protect them from loss while they are being carried in the ships.

Other Types of Insurance.—We have described the commoner types of insurance purchased by individuals and businesses to protect them against the ordinary risks of life. There are many other forms used for various purposes. As their purpose is clear from the nature of the insurance, we shall only mention them. Crops are insured against hail, wind, frost, and drought by market gardeners and tobacco growers. Rain insurance is bought by promoters of outdoor sports and exhibitions. Tornado, hurricane, and windstorm insurance is bought by those who live in regions subject to these happenings. Owners of stores insure their plate-glass windows. Then there is insurance that covers possible damage from strikes, riots, and loss of valuables by burglary. Banks insure their employees against loss by theft or robbery.

Summary.—All the factors of production are subject to many risks which affect the amount and regularity of income and often cause losses instead of gains. Many means have been tried to guard against these losses from the individual assumption of risks to insurance against such losses. Insurance is the method generally used today. Through insurance a loss too great for any one individual to bear is spread over a large number of persons and over a large area. Insurance

companies seek to reduce their liability by not accepting too many risks in any one community and by insisting that the one desiring insurance first prove that an insurable interest exists.

Insurance is of many kinds, covering practically every known risk that exists. The commonest form of personal insurance is life insurance. This is bought to protect dependents against loss of income due to the premature death of the wage earner. Fire insurance takes care of losses caused by fires; automobile insurance exists for all purposes connected with the operation of these vehicles; liability insurance affords protection to both workers and employers in case a worker is injured while at work. Those who own and operate ships obtain marine insurance and those who ship cargoes by water purchase cargo insurance.

Insurance exists for many other purposes, but whatever the kind it is intended to reduce losses that may be incurred in the operation of a business or in daily living. By the use of insurance the chances of loss of income may be lessened.

#### Questions to Test Your Knowledge

- 1. List several risks incurred by those who enter business.
- 2. How do you define insurance?
- 3. State the underlying principles of insurance.
- 4. What is meant by insurable interest. Give an example.
- 5. Define the following terms: policy, premium, beneficiary.
- 6. Name the common forms of life insurance policies.
- 7. Distinguish between an ordinary-life policy and a limited-payment life policy.
- 8. What purposes may be served by buying term insurance?
- 9. How does an endowment differ from a whole-life policy?
- 10. How may annuities be purchased? Why are they purchased?
- 11. What is the purpose of fire insurance?
- 12. In what ways does automobile insurance help to reduce possible losses?

#### Questions for Discussion and Application

- 1. Discuss the reasons why insurance on property is purchased.
- 2. Why would it not be possible or wise for an individual to assume the entire risk of losses by himself? Can you name any instances in which individuals do assume such risks by themselves?

- 3. Why do insurance companies insist upon an insurable interest before they will permit a person to insure property or a life?
- 4. Examine a standard fire insurance policy and be ready to report to the class on the terms contained in the policy.
- 5. It is said that it is possible to insure against any possible happening if one is willing to pay the price. Do you think this is true? Can you think of anything that cannot be insured?
- 6. Explain why it is unwise to insure property for more than it is worth. What happens when a fire destroys property that has been insured for more than its value?
- 7. Explain the type of risks covered by liability insurance. Why should a contractor incur the extra expense of insuring his workers? Show how this type of insurance may be advantageous to workers? Might it prove to be a disadvantage? Explain.
- 8. List several advantages of insurance to (a) businessmen, (b) private individuals, (c) working men.

#### Floor Talks and Written Reports

- 1. The history of insurance.
- 2. The abuses of fire insurance.
- 3. The value of life insurance.

#### Topic for Debate

RESOLVED, That all those who employ others or who operate automobiles should be compelled to carry liability insurance.

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#### PROBLEM 28

#### How Much Insurance?

Arthur Johnson is thirty-two years of age. He is married and has two children, one ten years old and the other six. He owns the house in which he lives, but it is mortgaged for \$3,000. He also owns an automobile, which is used for family purposes and to carry him to work each day. At the age of thirty he started a small business in a store which he bought with money borrowed from the local bank. He is obligated to repay this money over a period of ten years. To carry on his business he bought a small delivery truck and hired a man to drive it. He has an extensive stock of goods and employs a clerk. His business has been successful and he feels that, if he can live and keep his health, he will be able to pay off all debts and make a good income.

- 1. What types of insurance should Johnson carry?
- 2. What is the least amount of fire insurance he should buy?
- 3. How much life insurance would it be wise for him to purchase?
- 4. What type of life insurance would you recommend? Why?
- 5. Would term insurance be of any help to him? How?
- 6. Should he carry any liability insurance? If so, what type or types should it be?
- 7. What points should Johnson consider in deciding his insurance problems?

#### PROBLEM 29

#### What Kind of Insurance?

The Brownells have to face the problem of protecting themselves against the many risks that may arise in their daily lives. Mr. Brownell's business is such that he may easily be injured. He is the breadwinner of the family, and the present and future welfare of all depends almost entirely upon him. There may be accidents in the home, someone may need a serious operation, or medical care may be required by one or more of the family. The house should be insured against fire, and so should the furniture and the automobile. The budget limits the Brownells' ability to have full protection, but they must protect against the most likely risks.

- 1. Which member of the family should carry life insurance?
- 2. Should the father also carry health and accident insurance?
- 3. How much fire insurance should be carried on the house and the furniture?
- 4. What kinds of automobile insurance should be purchased?
- 5. Look up hospitalization insurance. Would the family be wise to buy this type of insurance?
- 6. What other kinds of insurance would you recommend in view of the limited amount set aside for this purpose?

#### Part V

# Organization of Capital and Labor

Chapter XXIV:

**BIG BUSINESS AND MONOPOLIES** 

Chapter XXV:

TRANSPORTATION AND COMMUNICATIONS

Chapter XXVI:

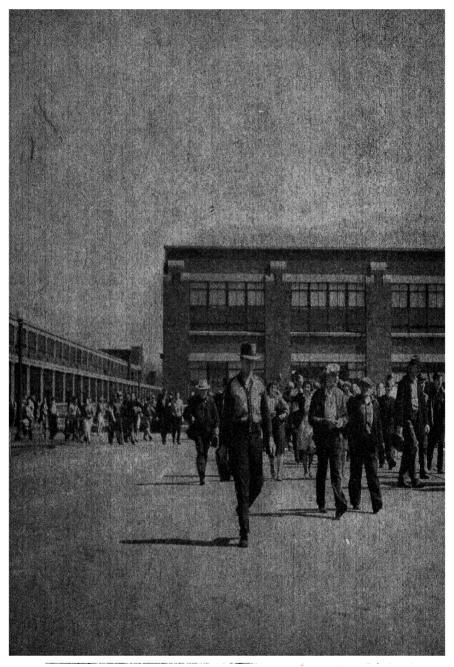
HOW AND WHY LABOR ORGANIZES

Chapter XXVII:

AIMS AND METHODS OF LABOR UNIONS

Chapter XXVIII:

EMPLOYERS' ATTITUDE—SETTLING DISPUTES



Farm Security Administration, Photo by Vachon

BIG BUSINESS—Both capital and labor are needed if goods are to be produced in the quantities we require. Here is a shift of laborers leaving a plant at 4 p.m. About 10,000 are employed in this plant.

## Chapter XXIV

# Big Business and Monopolies

#### Aims of This Chapter:

To learn what monopoly or big business is.

To examine the kinds of monopolies.

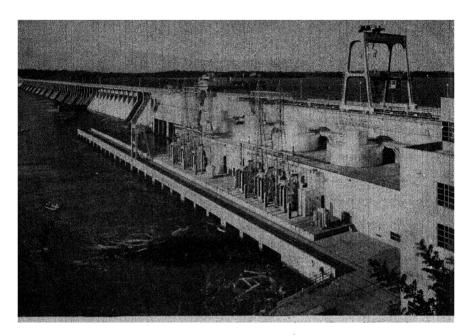
To discuss the forms of capitalistic combinations.

To learn why businesses combine.

To find how monopoly price is determined.

We have stated that the corporation has become the most outstanding form of business organization in the United States. Its advantages and disadvantages were discussed in Chapter VIII; you observed that it has exerted great influence in the business and investment world. The corporation has grown from the small firm with a few stockholders to the gigantic firms with thousands of stockholders. The corporation, however, has not been content with merely growing in size within its organization. One corporation has combined with other corporations to form what may be called "supercorporations." These capitalistic combinations are now found in many fields, especially in public utilities and large manufactures. They have become known as "trusts" or "monopolies." This chapter will discuss how these combinations arose, and what forms they have assumed.

What Is a Monopoly?—Monopoly may be defined as control over the supply of some economic good sufficiently to fix the price of that good. The essence of a monopoly lies in its ability to control supply sufficiently to be able to regulate the price. It is not necessary to control the entire supply but merely enough to give such control. Monopoly also implies a lack of competition. A monopoly is said to exist when there is only one enterprise engaged in a given type of business or when several enterprises unite in such a way that they are able to adopt a common price policy.



Courtesy of Tennessee Valley Authority

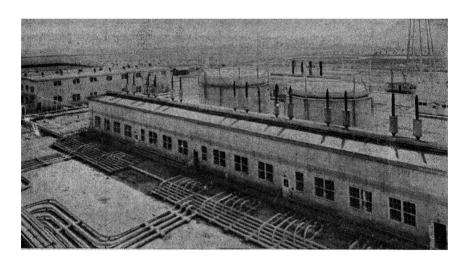
PUBLIC LEGAL MONOPOLY—Outdoor-type generators at TVA's Wheeler Dam in northern Alabama, at the head of Muscle Shoals, help produce 10 billion kilowatthours of electricity a year. This is sold at low cost to Tennessee Valley homes and industries.

Monopolies Are of Several Kinds.—Monopolies exist today in many different forms. We shall describe only the commoner forms.

Legal Monopolies.—These are monopolies that exist because they have been created by law. Although it has always been believed that competition in business is desirable, the government has decreed that in certain industries competition is undesirable and expensive. Therefore, the government has granted monopoly privileges to private individuals and to corporations; it has reserved the right to operate certain industries and to control or regulate certain services to the public. There are two classes of legal monopolies: public and private.

Public legal monopolies are those which are operated by the government itself in the interests of the people as a whole. The United States government has a complete monopoly of the manufacture of our paper money and metal coins. It also operates the postal service and the Tennessee Valley project. Many cities and towns own and operate their water systems, electric-light and -power plants and gas plants.

Private legal monopolies are those created by law but operated by private persons or corporations. These monopolies are of several kinds.



Courtesy of United States Department of the Interior

NATURAL MONOPOLY—The discovery of helium in certain natural-gas wells in the United States (1903, 1907, 1915) has supplied a noninflammable gas which could be used in lighter-than-air craft. We have a natural monopoly of helium since the wells in this country are the chief source of supply. The above picture is a view of U. S. Bureau of Mines, Otis Helium Plant, Otis, Kan.

There are patents which grant the owners an exclusive right for a period of seventeen years to manufacture and sell devices or processes they have invented. Copyrights are monopolies granted to those who produce books, songs, pictures, magazines, and news items. An exclusive right to control and market the product is granted for a period of twenty-eight years with the privilege of renewal. Then there are franchises, which are licenses to corporations and individuals to carry on certain lines of business. These are usually found in the field of public utilities. Franchises are granted to railroads, telegraph and telephone companies, electric-light and -power companies, and broadcasting companies. Private monopolies are granted in patents and copyrights because it is believed that it is in the public interest to encourage talent. Private monopolies may be granted in franchises because competition in the public-utility field would be wasteful and inconvenient.

Natural Monopolies.—These monopolies arise because of some set of special circumstances or some unusual ability, talent, or personality. They are of two kinds.

Those due to a limitation of the supply of some natural resource.—Illustrations of this kind of natural monopoly would be anthracite in Penn-

sylvania, rubber in the East Indies, and helium gas in our country. Another illustration would be the control exercised over a mineral spring whose waters have medicinal qualities.

Those due to unusual personal qualities.—These are sometimes referred to as personal monopolies because they are exercised by individuals. When a person possesses some unusual ability or personality which enables him to demand a high price for his services, he has a natural monopoly. Singers, movie stars, orchestra conductors, or violinists of outstanding reputation are examples. They are in a position to dictate their own price because they control the only supply of a particular talent.

Labor Monopolies.—These monopolies are said to exist when skilled workers through closed unions are able to control the supply of their particular kind of labor. When labor unions become so strong that they can force employers to hire only their members or can limit the number of apprentices they will receive into their union, they are exercising a monopoly. Examples of this are in some building trades of our large cities.

Capitalistic Monopolies.—These are monopolies which exist because the corporations forming these combinations have accumulated such large amounts of capital that they are able to prevent others from competing successfully with them. Their size alone makes it impossible for competitors to survive. Among the better known may be mentioned the Aluminum Company of America, the American Tobacco Company, and the United States Steel Corporation. It is with that type of monopoly that this chapter deals.

What Are Capitalistic Monopolies?—There is a tendency for large corporations to unite with other corporations to form still larger capitalistic combinations or supercorporations. Among these are the pool, the trust, the holding company, and the merger.

Pool.—This is a secret agreement to divide profits, output, or territory among the members of the pool according to certain arrangements. It is the earliest form of combination in the United States. Pools were commonly found in railroads and some manufactures.

In the pool the member corporations retained their independence except for the rights that were handed over to the pool. The earnings of the units in the pool might be paid into a common treasury to be divided among them according to some ratio agreed upon. Sometimes patents were pooled, and business was divided among the members. Pools were liked because they could be organized easily: they enabled the members to control prices; and they eliminated some competition. But the pool had its weaknesses. The members of the pool did not always like the arrangements about division of profits and output; consequently, they often broke their agreements. Moreover, members of the pool frequently used the knowledge about competitors to their own advantage. Pools were restraints of

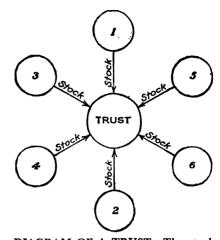


DIAGRAM OF A TRUST—The stock of the six competing companies is handed over to a single board of trustees, who thus are able to control the competition, fix the prices, and assign the territory for all six corporations.

trade and so were illegal. A member who had a grievance against the pool could not take his case to court but had to depend wholly upon the honor of those who were in the pool with him.

Trust.—When trusts were first organized they meant something different from what they are considered today. Originally a trust meant a combination of corporations in which the stock of the uniting corporations was turned over to a board of trustees in order to create a unified business control over the members. Thus a trust was a combination of corporations. The trustees held the assigned stock in trust and in exchange for it issued trust certificates upon the basis of which the profits were divided. The trustee was given the power to elect the directors of the corporations in the trust. This made it possible for the trustee to control the policies of the combination, to regulate the output and the price.

The trust had certain advantages over the pool. Pools were only temporary and depended wholly upon the honor of the members. But the trust was longer lived; it depended upon a written agreement. The courts ruled that trusts were restraints upon competition; both the states and the Federal government passed laws to curb them. This brought about the dissolution of the trusts and the adoption of other forms to accomplish the same ends. However, the term "trust" has

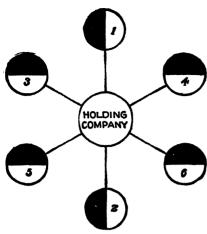


DIAGRAM OF A HOLDING COM-PANY—This is a combination of competing corporations over half of whose shares of ownership are owned by another corporation called a "holding company." The holding company thus controls the business of the entire six corporations, which are called "subsidiaries."

survived. Today it refers to any form of business organization large enough to control its field. In other words, as popularly used today, a trust is any industrial combination or "big business."

Holding Company.—A holding company is a corporation that owns a controlling share of the stock of the corporations in the combination. The corporations making up the holding company are called "subsidiaries." The subsidiaries are permitted to have their own officers, but these are usually selected by the holding company which dictates their policies. Some holding companies are operating companies, but many of them are merely managing companies.

The holding company is easily organized. All that is needed is to buy the stock of the desired companies in the open market until enough is obtained to give control of the companies. Thus a company holding a little more than half of the stock of another company gains control over it.

Holding companies have often been built upon other holding companies. This is called "pyramiding." Through pyramiding, it has been possible for one company to control the affairs of many other companies situated far away.

The holding company differs from the trust in that, instead of being a combination of corporations, it is an independent corporation. It is found in the fields of transportation, public utilities, manufacturing, and mining. The New York Central Railroad, the North American Company, and the United States Steel Corporation are good examples of holding companies.

Merger and Consolidation.—The holding company controls but does not dissolve its subsidiary corporations. A merger is brought about when a new corporation buys up all the stock of other corporations and then dissolves these corporations. Consolidation takes place when

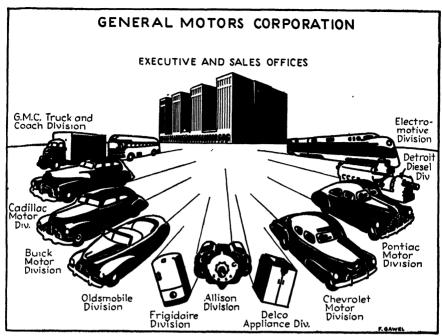


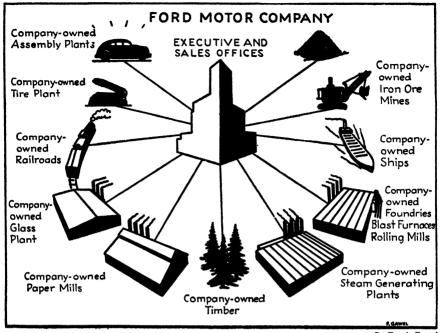
Chart prepared by Frank Gawel, with permission of General Motors Corp.

HORIZONTAL COMBINATION—General Motors Corporation is organized as a horizontal type of combination because all of its divisions are under the control of one central management. Here a number of competing companies have been united into one corporation comprised of over forty divisions, a few of which are shown above.

one of several competing companies buys the stock of its rivals and thus puts them out of business. By either method there remains only one corporation which has completely absorbed all the others. Examples of mergers are the General Electric Company, American Tobacco Company, and the International Harvester Company.

How Are Combinations Organized?—There are two common methods of forming these capitalistic combinations: (1) horizontally and (2) vertically.

Horizontal Combinations.—When two or more formerly competing companies unite under one management, we have a horizontal combination. An excellent example of such a combination is General Motors, which manages from one central office the many automobile companies, the Frigidaire Corporation, and Fisher Body Corporation. Each individual plant in the combination conducts its own opera-



By Frank Gawel

VERTICAL COMBINATION—The Ford Motor Company is organized as a vertical type of combination because it controls a great proportion of the raw materials, factories, and transportation facilities needed to produce the Ford car and other Ford products. Some of these Ford-owned agencies appear in the drawing above.

tions, makes its own product, has its own employees, does its own advertising and selling. But all this is accomplished under the direction of the central management.

Vertical Combinations.—These are associations of several concerns each of which is engaged in the production of some part essential to the finished product. For example, the United States Steel Corporation includes iron mines, iron and steel mills, railroads, ships, plants for producing bridge and structural steel, warehouses, etc. The Ford Motor Company is another example of a vertical combination. These combinations are sometimes spoken of as integrated industries because they bring together under one control all the activities of a particular industry.

Why Are Capitalistic Combinations Formed?—There are many reasons why these huge combinations are formed, but we have space for the consideration of only three basic reasons.

To Eliminate Competition.—This is a very prominent reason for the formation of combinations. Naturally, if competitors can be eliminated, there will be more opportunity for the combination to control the field. By combining several corporations into one, the new organization obtains almost a monopoly because its very size discourages competition.

To Regulate Output and Maintain Prices.—This is what all combinations desire. When competition exists, there is a tendency to cut prices in order to obtain business. Sometimes the process of price cutting goes so far that many businesses are ruined. This is called "cutthroat" competition. It is to stop this practice and to stabilize prices that combinations have been formed. It is not difficult to see that if a combination can control such a large part of the output that consumers become dependent upon it for their supply, it can materially affect the price of the article that it has to sell. If the combination lowers prices, competitors must do likewise; if the combination raises prices, competitors do the same. Thus the combination through its price policy influences competitors. In this way a strong combination in any field has a stabilizing effect on market prices.

To Gain Profits.—It seems hardly necessary to state that this is an important purpose of forming combinations. If a combination can control output and regulate prices, it can earn huge profits, and that is what is wanted.

How Does a Monopolist Fix His Price?—There is a very common idea that the monopolist always charges the highest possible price for his article because he has no competition. This seems logical because when no competition exists there should be nothing to prevent the charging of a very high price. Yet the monopolist rarely is able to set prices as high as he would like. A monopolist is like others who are in business; he wishes to make all the profit that he can. But experience has shown him that if he sets his price too high, many will refuse to buy his product. He knows that the more he can produce, the less it will cost him to produce each article. But unless he can sell all or most of what he produces, he may lose money rather than make any. His problem is to sell all his product and still make a good profit. He cannot control demand except as he changes his price. If his product is a necessity, he is in a better position to charge a high price and get it. But if his product is of the luxury type, he has to be

more careful because the demand for luxuries is elastic; that is, the effective demand for such articles falls off as the price rises and vice versa. Under these circumstances the monopolist experiments until he finds a price that will enable him to sell all or most of his product and obtain the greatest net profit. Thus the monopolist does not deliberately charge a very high price for his product but observes the law of monopoly price which states that a monopolist tends to set his price at the point that will give him the greatest net profit.

The accompanying table will illustrate how a monopolist determines his prices:

DDIERMINIO MONOTOLI I RIGE						
Quantity sold	Unit cost	Total cost	Selling price	Total income	Net profit	
200,000	\$0.50	\$100,000	\$1.00	\$ 200,000	\$100,000	
400,000	0.45	180,000	0.90	360,000	180,000	
800,000	0.40	320,000	0.80	640,000	320,000 *	
1,200,000	0.35	420,000	0.70	840,000	420,000	
1,600,000	0.30	480,000	0.60	960,000	480,000	
2,000,000	0.25	500,000	0.50	1,000,000	500,000	
2,200,000	0.20	440,000	0.40	880,000	440,000	

DETERMINING MONOPOLY PRICE

A study of this table shows that the monopolist makes the greatest net profit when he sets his price at 50 cents. Under the conditions illustrated in this table that will be the monopoly price. Of course this is not an actual case and in actual experience the figures might be different. But the example serves to show the procedure the monopolist uses to arrive at his price. It implies that he has no competition and so is not afraid that someone will undersell him.

What Prevents a Monopolist from Charging Any Price He Chooses?—The monopolist refrains from charging too high a price for three reasons:

Competitors May Enter the Field.—As soon as it is discovered that a monopolist is making high profits from the sale of a particular article, others will attempt to produce a similar article and obtain a share of the profits. This results in an increase in the supply of the article, and the price will have to be reduced in order to dispose of the entire supply. The monopolist, too, is forced to lower his price, and soon his monopoly has disappeared.

Consumers Will Seek Substitutes.—Even though no others enter the field to share his profits, the monopolist is not free from difficulties. If his price is too high, consumers will object to paying it and will look for substitutes. Even though the substitute may not be so good as the monopoly product, consumers will buy it rather than pay an excessive price. If enough consumers do this, the monopolist will be compelled to lower his price and again his monopoly has gone.

Government May Interfere.—If the monopolist persists in maintaining a price that consumers consider too high and if the article happens to be one that people need, the monopolist may find that the government will step in and either regulate the price or the business itself. This has happened many times through laws which forbid monopolies altogether or which regulate them in the interests of consumers and competitors.

Summary.—A monopoly is control over the supply of a commodity or service sufficient to enable the holder to set the price. Monopoly exists in several forms. There are legal monopolies, which may be public or private. Public legal monopolies are those operated by some form of government in the interests of the people. Private legal monopolies are created by law but are operated by private individuals or corporations. Natural monopolies arise because of some special set of circumstances or some unusual ability, talent, or personality. Then there are labor monopolies such as are found in some labor unions, and capitalistic monopolies, which result from great industrial combinations.

The primary aim of business combinations is to eliminate competition in order to exercise control over supply and prices. To accomplish this, several forms of combination have been devised. Among them are the pool, the trust, the holding company, and the giant corporation resulting from mergers or consolidations. These combinations have been organized horizontally and vertically. Each form has its advantages and its disadvantages, but all are illegal whenever they restrain competition unreasonably.

The monopolist wishes to make as much profit as possible, but he knows that he cannot set his price too high or he will lose money. So he experiments until he finds a price that will enable him to make the greatest net profit. This is the monopoly price. He has to guard against possible competitors, against driving consumers to the use of substitutes, and against interference by the government.

### Questions to Test Your Knowledge

- 1. What is a monopoly?
- 2. Name the various kinds of monopolies.
- 3. Distinguish between public and private legal monopolies. Give a few examples of each.
- 4. What forms do natural monopolies take?
- 5. When does a labor monopoly exist?
- 6. What are capitalistic monopolies? Name one or two.
- 7. How is a pool arranged? What is its purpose?
- 8. What advantages do trusts have over pools?
- 9. How are holding companies formed?
- 10. Explain how mergers are brought about.
- 11. Distinguish between a horizontal and a vertical combination.
- 12. State the law of monopoly price.
- 13. Why cannot a monopolist set his price as high as he pleases?
- 14. State the chief reasons for forming combinations.

#### Questions for Discussion and Application

- 1. A monopolist may control supply, but he has little or no control over demand. Explain this statement.
- 2. Give several reasons why it is preferable to allow public utilities to exercise monopoly privileges. Have public utilities taken an unfair advantage of their privileges? Explain.
- 3. Give several reasons why a monopolist does not charge so high a price for his product as he might like to charge. Which of these reasons do you consider the most effective in restraining the monopolist?
- 4. Summarize the advantages of pools, trusts, holding companies, and mergers.
- 5. Are labor monopolies very effective? Does a strong labor union actually exercise a monopoly over the labor it represents? Do you think labor monopolies should be permitted to exist? Discuss.

#### Floor Talks and Written Reports

- 1. Social implications of labor monopolies.
- 2. Personal monopolies.
- 3. The holding company.

#### Topic for Debate

RESOLVED, That all corporations engaged in interstate commerce should be chartered by the Federal government.

### For Further Information

Arnold, T. W., "The Bottlenecks of Business."

Gemmill, P. F., "Fundamentals of Economics," Chaps. 21, 22.

Hendrick, B. J., "The Age of Big Business."

Josephson, M., "The Robber Barons."

McGrane, R. C., "Economic Development of the American Nation," Chap. 23.

Patterson, S. H., and K. W. H. Scholz, "Economic Problems of Modern Life," Chaps. XXI-XXIII.

Public Affairs Pamphlets, "The American Way," No. 90.

Taylor, H., and Associates, "Main Currents in Modern Economic Life," Chaps. 15, 16, 17.

Wormser, A. M., "Frankenstein, Inc."

#### PROBLEM 30

#### What Will Be the Monopoly Price?

From the data given in the accompanying table, determine what the monopoly price will be. Answer the questions below.

Units sold	Unit cost	Total cost	Sale price	Total income	Net profit
5,000 10,000	\$2.00 1.50		\$5.00 4.50		
15,000 20,000 25,000	1.00 0.75 0.50	•	4.00 3.50 3.00		
30,000 35,000	0.40 0.30		2.25 1.75		

- 1. What is the monopoly price?
- 2. State the law of monopoly price.
- 3. Will the monopolist necessarily set his price at exactly this point?
- 4. What should the monopolist take into consideration in setting his price?
- 5. Name some articles that would not be subject to a monopoly price.

# Chapter XXV

# Transportation and Communications

#### Aims of This Chapter:

To appreciate the importance of transportation.

To review the development of railways.

To discuss the characteristics of railroad operation.

To learn about the newer means of transportation.

To examine the story of our merchant marine.

The discussion in the preceding chapter dealt mainly with the problems of manufacturing and selling. But big business exists in other lines than manufacturing and could not function efficiently if it were not for our transportation system. Transportation has developed from canals, toll roads, highways, and local railways to ocean traffic, superhighways, and transcontinental railroads. Today we have transportation by land, water, and air, all of which are essential in our economic life. In this chapter we shall discuss some of the problems confronting the transportation system of our country.

What Makes Transportation Important?—When you stop to consider what would happen if there were no modern means of transportation, you will get some idea of the importance of having effective ways of getting our goods from factories and mills to consumers. How much of a breakfast would you have had if the food had not been brought from some distant point? Probably your coffee came from Brazil; your fruit from Florida or California; your cereal came from the West or the Northwest; the fuel used to cook the food probably came from Pennsylvania or the oil fields of Texas or Oklahoma. Even the materials from which your house was built came from some distant place. The radio, the refrigerator, the household furniture and equipment, and even the books and papers which



Farm Security Administration, Photo by Lee

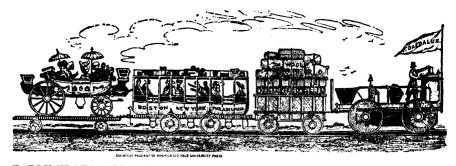
TRANSPORTATION OF PERISHABLE GOODS—A truck carries milk from the dairy to a city market. Speed is essential in transporting perishable goods.

you read would have been impossible had there not been a means of getting the materials from places far away from your home.

The very finest and most useful articles are of no value to you unless they are where you can get them and use them. Value is added only when goods are transported to places where these things do not exist in sufficient quantities to satisfy the needs of people who want them. The farmer, the manufacturer, the merchant, and the consumer are all dependent upon some means of transportation for their very existence.

There is another reason why we should be vitally interested in our means of transportation. Nearly every one of you has a small account in a savings bank or a life insurance policy. In order to earn money with which to pay interest on savings deposits and to pay the insurance money when someone dies, the banks and insurance companies invest their surplus funds in the bonds of railroad companies. When the railroads do not earn enough to pay interest on their bonds, the banks and insurance companies do not earn enough to pay you interest; in this way you may suffer some loss. Thus you see it is very essential that the means of transportation be maintained efficiently.

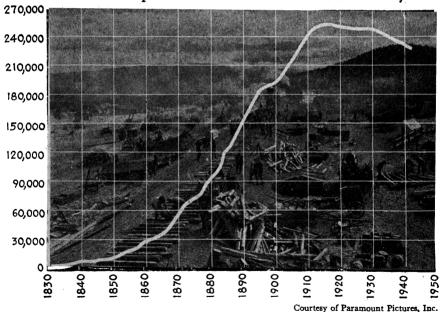
The Development of Railroads Was Not a Hasty Process.—The first railroad in the United States which was opened for traffic was the Baltimore and Ohio in 1830. At that time there were only 23 miles of railroad in the entire country. By 1840 this had increased to about



EARLY TRAIN—This train of 1832 was made up of locomotive, freight car, passenger coach, and private horse-drawn carriage hoisted on a flatcar. The engineer wore a plug hat while on duty.

3,000 miles. When the Civil War began, there were in operation about 40,000 miles of railroad. After the war the increase in railroad mileage was rapid; by 1931 there were 796,541 miles in operation; but by the close of 1933 this had decreased to 425,664 miles, according to reports issued by the Interstate Commerce Commission.

The first railroad lines were local affairs serving purely local interests. The next step was to connect the local lines of one city with



MILES OF RAILROAD IN THE UNITED STATES—The picture shows men at work extending the Union Pacific rails that connected California with the East in 1869. The chart shows how quickly the miles of railroad track were laid after the public "believed in" railroads.



Courtesy of St. Louis Post Dispatch and Fitzpatrick

A RACE AGAINST DEBT—The cartoonist pictures the railroads racing to keep ahead of receiverships. Roads that fail in business are managed by receivers, who try to put them on a sound business basis again.

the local lines of another city. Then came the building of transcontinental lines. Many problems were involved in this task; huge sums of money and immense tracts of land were given to the railroads by the national government and the various states. To the transcontinental lines, the United States granted about 100 million acres of public land. You will have a better idea of what this means when told that it is about equal to the area of the state of California.

The story of the building of our large railroad system is not an altogether creditable one. So great was the desire of people for railroads that some construction was done hastily, much material and money were wasted, and many more lines were built than were needed. Speculation in railroad stocks and bonds was widespread and

many public officials were bribed to favor railroad projects. Little attention was paid to economy in operation or to efficiency in construction and management. The result was that many railroads could not earn expenses and went into bankruptcy.

There Are Definite Characteristics of Railroad Operation.— Operating a railroad differs in some respects from the operation of other businesses. This is partly due to the nature of railroads. Let us examine these characteristics.

Railroads Are Subject to Heavy Overhead Expenses.—It has been said that it costs nearly as much to have a railroad stand idle as it does to operate it. Certain expenses continue whether a train moves or not. Taxes must be paid under any circumstances, salaries must be met even when the trains do not run, and interest on bonds must be paid. Moreover, the roadbed must be kept in good condition, and signal systems must be maintained.

Increasing Returns or Decreasing Costs.—Because there are certain fixed overhead expenses in operating a railroad, it follows that as the traffic handled increases, the earnings increase even more rapidly. As the traffic handled increases, the operating costs increase too, but only in proportion to traffic. The total costs, however, do not increase in proportion to the increase in traffic. Another way of stating this characteristic is to say that as traffic increases, the cost per unit tends to decrease. Thus, railroads operate under the principle of increasing returns or decreasing costs.

Railroads Cannot Easily Apportion the Costs of Services.—Railroads perform a vast variety of different services. They move some goods in carload lots, some in trainload lots, and some in less than carload lots. Some goods are transported short distances and some long distances. The same tracks are used by passenger and freight trains. Sometimes one locomotive hauls both passenger and freight cars in the same train over the same track at the same time. It is almost impossible to tell what part of the joint cost belongs to the freight traffic and what part to the passenger traffic. The expenses must be borne jointly by both kinds of traffic. Thus railroads are said to operate under the principle of joint costs.

Railroads Charge What the Traffic Will Bear.—Because it is impossible to tell definitely what each item costs the railroad to carry, the

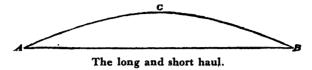
railroads ordinarily place upon each particular kind of freight a rate that will bring them the greatest revenue. Railroads have found that they can charge high rates for goods of high value, but that they must fix low rates for goods of low value if they are to keep the business. Thus railroads can charge a high rate per pound to the shippers of silk. But if they should charge this same rate per pound to the shippers of coal, they would lose the business of carrying coal. Railroads, therefore, charge a high rate for valuable articles because they can get it. The rate for each kind of freight is made high enough to be profitable to the railroads, but not so high that the articles will not be shipped. This method of making rates is called "charging what the traffic will bear."

Why Did Railroads Become Unpopular?—It has already been stated that there were inefficiency and waste during the early years of rapid railroad expansion and that many unfair practices were indulged in so that the railroads might make profits on their large investments and sometimes on their watered stock. Some of these errors and abuses became deeply embedded in the complicated structure of railroad rates and have come down to the present as, a plague upon honest efforts at efficient management. The chief of these unfair practices were rate discriminations, which will be described briefly.

Discrimination as to Commodities.—This kind of discrimination exists when the freight rate for transporting certain commodities is lower than the rates on other commodities or are lower under certain conditions than under other conditions. For example, the rate for shipping wheat might be higher than for shipping flour; or the rate for shipping cotton might be much lower than that for shipping iron ore. Again, a manufacturer of refrigerators might obtain a special rate which his competitors could not obtain. This would give him a decided advantage over his competitors.

Discrimination as to Localities.—This is sometimes known as the long haul vs. the short haul. Lower rates were given from one shipping point to a given distant point than to other points not so far away. For example, the rate from New York to Boston might be less than the rate from New York to various small towns on the same railway line. Railroads defended this practice on the ground that there was competition at the farthest points but none at the intermediate points.

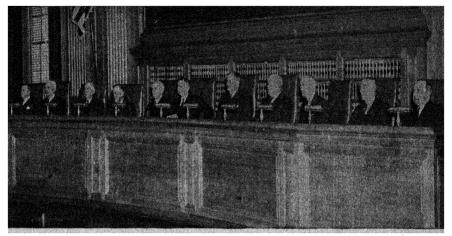
The accompanying diagram will illustrate this. The railroad running between A and B directly is a competitor of the railroad running from A through C to B The rates on the line running through C might be greater for goods going to C than for goods going through C to B. This is because there is no competition from A to C, but there is competition from A to B.



This discrimination between long and short hauls had disastrous consequences for certain sections of the country. Although this practice has been forbidden in general, it is still permitted under certain conditions.

Discrimination as to Shippers.—This is known as rebating. It was considered the worst form of discrimination because it meant that certain favored shippers were charged a lower rate on their goods than was allowed their competitors. As a rule, the railroads favored those companies that were engaged in big business and the rebate was given whether they shipped much freight or not. Rebates were allowed in a variety of ways and were often of sufficient importance to enable the favored shipper to drive his competitors out of business and so establish a monopoly. It is said that this was one of the means used by the Standard Oil Company to gain its early monopoly power. An investigation showed that the Standard Oil Company had an agreement with a certain railroad to transport oil for 10 cents a barrel between two places although other companies were being charged 35 cents a barrel for the same service. In addition to this preferential rate the Standard Oil Company received as a rebate the excess charge of 25 cents which competing companies had to pay.

The Federal Government Steps In.—Owing largely to the unfair practices and abuses just described, there began to develop a hostility to railroads and a demand that their activities and rates be regulated. At first the states tried their hand at regulation, but they were handicapped by the fact that they could legislate only for railroads that were within their boundaries. Railroad business is mostly interstate, and control over this kind of commerce is granted to Congress by the Constitution. Thus Congress was given power to



Acme Photo

INTERSTATE COMMERCE COMMISSION—Here are the eleven men who regulate the railroads, pipe lines, motor busses and trucks, and express companies. This important group has played a great part in coordinating and controlling rates.

make laws to regulate railroads, the most important of which will now be discussed.

Interstate Commerce Act, 1887.—This act created the Interstate Commerce Commission, which was given the power to hear complaints and make investigations, but their decisions were not binding on the railroads, which could appeal to the courts. The law forbade unjust discriminations between shippers, places, or industries; the charging of unreasonable rates; and the pooling of earnings.

There were many loopholes in the law of which the railroads were quick to take advantage. The law provided no suitable penalties for violations of its provisions. This state of affairs has been remedied by several amendments which tend to give more power to the Commission. It can now fix rates; it can compel railroads to adopt a uniform accounting system; it can supervise the combination of two or more railroads for purposes of economy in operation and management. It now has control over pipe lines, private and sleeping car lines, and express companies. Recent legislation has placed motor transportation under control of the Commission.

Transportation Act of 1920 (Esch-Cummins Act).—This was the act that turned the railroads back to private management after the government had operated them during the First World War. It encouraged the consolidation of the large number of railroad systems in the country into a few large railroad systems. Under this law the roads were allowed to earn 6 per cent profit upon a fair valuation of

their property. The so-called "recapture clause" provided that any railroad earning more than 6 per cent must pay one-half of the excess to the government and the other half into a revolving fund from which weaker railroads could borrow for new equipment. This clause was repealed in the emergency legislation of 1933, which also created a *Federal Coordinator of Transportation*, who had full power to control the traffic of the railroads and regulate their financial policies.

Railway Labor Act of 1926 (Watson-Parker Act).—This act set up a rather complicated method of settling railway labor disputes. The employers and employees must first try to settle their own disputes. If they cannot do so, then several steps are to be taken until the dispute finally reaches the President, who appoints a board to investigate. While the investigation is in progress and for thirty days after it reports to the President, there can be no action by either of the parties to the dispute. In 1934, the act was amended. A National Mediation Board was set up with power to settle labor disputes of the railroads.

Railroads in Second World War.—On December 18, 1941, the President created the Office of Defense Transportation (ODT). The Director was given jurisdiction over railroad, motor, inland waterways, pipe lines, air transport, and coastwise shipping. Except for a short period of time—December 29, 1943 to January 18, 1944—the government did not take over the railroads, as in the First World War, but restricted its functions to serving, through the ODT, as a coordinating and unifying body aiming to achieve the greatest efficiency. The railroads performed a prodigious task efficiently and aided the war effort in a most useful manner.

Heavy Debts of Railroads.—A serious difficulty that confronted the railroads before the Second World War was financial in nature. During the depression, railroads were obliged to borrow large sums of money from the Federal government, giving a mortgage on the lines as security. This huge railroad debt leads many to think that the only way it can be repaid is for the government to take over the roads. In 1921, the net income of the railroads was 501 million dollars. In 1943, this amount rose to over 600 million dollars. Perhaps this increased income due to the handling of war traffic will change the situation, but this cannot be answered with any surety until peace comes again.



Courtesy of Union Pacific Railroad Co.

THE RAILROADS' ANSWER—This air-conditioned and articulated train is electrically driven and can travel eighty miles an hour. Passengers ride in comfort. It is the railroads' answer to the competition of busses and airplanes.

Railroads Make Needed Improvements.—In order to meet the growing competition of the newer forms of transportation, the railways have developed a new type of train. This is streamlined, all in one unit, of light construction, driven by electric motors, and capable of very high speeds. Cars are air-conditioned and have added conveniences that make travel by train as comfortable as travel by automobile or bus. These new trains can be operated more cheaply than motor busses. Although the railroads have been slow to realize their position, they now seem to be making up for lost time. Much will need to be done to restore equipment worn out during the war. But with the experience gained from the war effort and with the added profits due to the war, the railroads may be able to regain their former leadership in the field of transportation.

Motor Transportation Assumes Importance.—The building of hard-surfaced roads connecting all parts of the country has made possible the use of motor transportation on an extensive scale. Motor vehicles have competed with railroads and taken from them much business that formerly was done almost exclusively by railroads. Busses and trucks have an advantage over railroads in that they do not require steel rails or private rights of way. They can operate on



Courtesy of American Trucking Association

TRANSCONTINENTAL TRUCK—This motor truck carries a large load with speed and safety to almost any part of the country. It has become a keen competitor of the railroads not only for short hauls but also for long ones.

any improved highway. Hence, they can be operated at less expense than railroad trains and can go to any destination desired.

Busses and trucks make such frequent and convenient stops that they take much business from the railroads. Motor trucks can be used for long or short hauls. The entire country is covered by a network of bus and truck lines, many of them running parallel to the railways. In some rural sections the busses have forced the railroads to abandon their services.

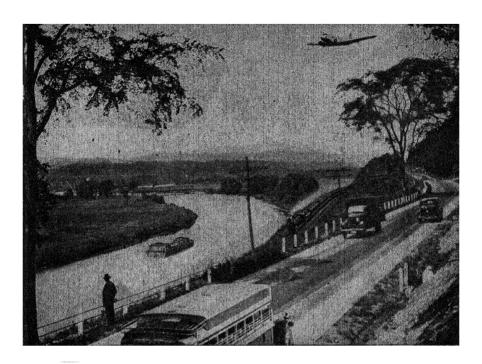
In 1935, Congress gave the Interstate Commerce Commission authority over truck and bus lines that were engaged in interstate business.

The busses use the highways built and paid for by the public. Although they pay for this privilege by means of gasoline taxes and

other taxes, they still are able to charge lower fares than the railroads can afford to charge. On the other hand, the bus is handicapped by the great amount of traffic on the highways in normal times; objections are being made to their use of the same highways as are used by private passenger automobiles. Railroads own their rights of way and are not restricted as to speed. Moreover, the railroad has no delays due to congested highways.

During the Second World War highway transportation became a vital part of the nation's wartime transportation system. Truck and bus services cooperated with the ODT in rearranging schedules, eliminating roundabout routes, and coordinating their services with that of other transportation divisions. The problem of competition with the railroads was resumed with the advent of peace.

Airways Compete with Roadways.—The latest means of transportation to be developed is the airplane, which has become an important carrier of mail, passengers, and light, valuable packages.



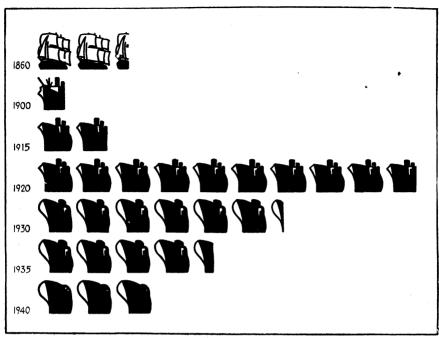
Ewing Galloway

COMPETITION—Bus, truck, barge, motor car, and transport plane often find themselves in direct competition, covering nearly identical routes.

Great improvements have been made in aerial transportation service; means are taken to make such travel as safe as travel on land. Faster and more efficient planes have been developed. Construction of airports and terminals has been increased. Public confidence in this new means of transportation has grown steadily, as shown by the number of passengers carried on domestic lines. These increased from 5,782, in 1926, to 4,060,545, in 1941.

As a result of peacetime progress, the air lines, at the time we entered the Second World War, had a total of 324 commercial planes in operation. In 1942, the War Department took over more than half of these and assigned them to carry military troops and cargo. During the war, quantities of huge transport planes were built which will be converted into passenger and cargo planes ready to offer stiffer competition to other means of transportation.

What About Our Merchant Marine?—American businessmen have been much concerned about the development of the merchant marine. In spite of great agitation for action not much was done about the matter until the First World War, which stimulated the building of thousands of ships flying our flag.

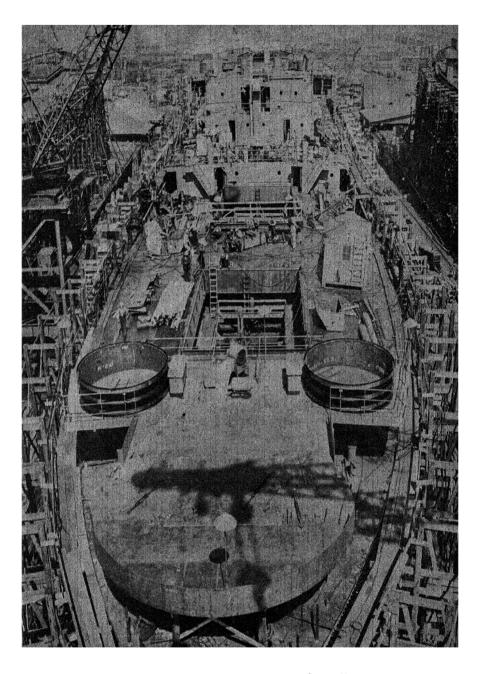


Frank Gawel

THE UPS AND DOWNS OF OUR MERCHANT MARINE—The marked decline in our merchant marine in the early 1900's parallels that which occurred following the First World War because of foreign competition. By 1935, our ships were few and old. Figures on American shipping industry after 1940 are not available.

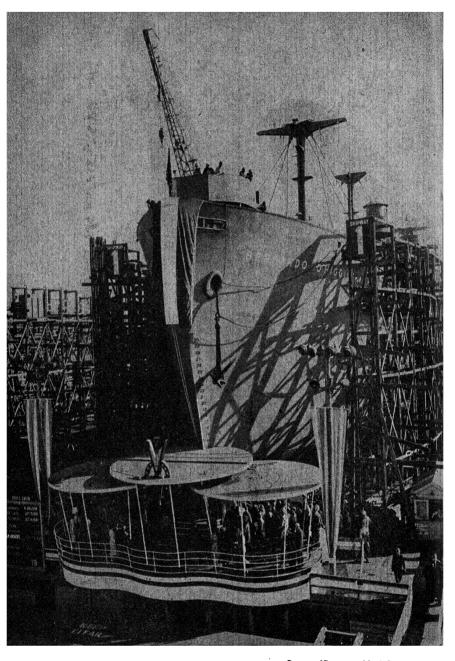
In 1920 Congress passed the Merchant Marine Act, which authorized the Shipping Board to operate ships on essential trade routes. Because the act favored private ownership and operation as a permanent policy, the board sold many of its finest ships to private companies at a great loss. Even with this help, American shipowners were at a disadvantage in competing with foreign shippers, and soon about 60 per cent of our carrying trade was being handled by foreign ships. It costs more to operate American ships, and foreign shipowners are usually paid large subsidies by their governments.

In an effort to meet this situation, Congress in 1928 passed a new Merchant Marine Act which authorized the Shipping Board to make loans at low interest rates to American citizens for building ships. The act also provides for what really amounts to a subsidy in the form of mail contracts. Objections were made to this indirect method of granting subsidies since no one knew just how much was granted. So in 1936 Congress passed an act that granted direct subsidies to



Courtesy of Permanente Metals Corp.

ON THE WAY—This is the way a Victory ship looks after fifteen days of work have been ended. Never before have merchant ships been built and put into service so rapidly as in the Second World War. These ships helped to build our merchant marine up to the leadership of the world.



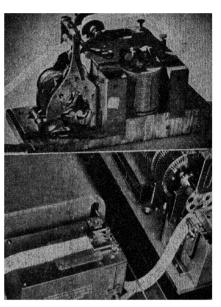
Courtesy of Permanente Metals Corp.

A VICTORY SHIP—A scene at the launching of one of the ships which played so important a part in winning the war. Thousands of these ships were built and used during the war. They carried precious cargoes across the Atlantic and Pacific to our fighting forces and to suffering peoples.

our merchant marine. The object of this act was to place American shipping interests on an equal footing with subsidized foreign interests. The act also created a *Maritime Commission* of five members to carry out the terms of the act.

When we entered the Second World War, it soon became evident that the fate of the entire war for the United Nations depended upon American ships. The immense quantities of war material being produced in our factories would be useless unless ships were produced to carry them to the places where they were needed. The problem was tackled, and a program was drawn up under which we have built thousands of ships. This will leave us with the largest merchant marine in the world.

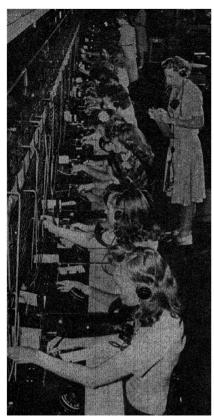
Our Communications System Is Extremely Important.—We have seen that an adequate system of transportation for carrying on domestic and foreign trade is an absolute essential to the functioning of modern life and industry. Almost as necessary is a means of communication by which businessmen can inform themselves of industrial conditions and direct distant enterprises. By the aid of a good system of communica-



World Photo

100 YEARS APART—It was with the instrument shown in the upper photograph that Samuel F. B. Morse flashed his first telegram between Washington and Baltimore on May 24, 1844—a century ago. Below is a close-up of the Western Union Telegraph Company's device which translates a telegram into holes on a tape, and then passes the message along to the boxlike apparatus, where it is relayed quickly and automatically to its destination.

tion, producers, manufacturers, and merchants may be constantly informed about trade conditions, price changes, and other factors that might affect their actions. The weather bureau has rendered important service to farmers and shipping interests by notifying them of anticipated changes in the weather. The modern newspaper, with its daily news items from all over the world, owes its rapid growth to rapid means of communication. Individuals are also benefited by communications as it brings them information that enables them to govern their daily conduct. An excellent example of



Courtesy of American Telephone and Telegraph Company, Photo by Handy and Buesser

A TELEPHONE SWITCH-BOARD—The switchboard at which these operators sit contains miles of intricate wiring which makes it possible to set up the connections for telephone calls. There are 18,800 telephone central offices in the United States, in which many types of switchboards are used. This one is in a large city.

the value of rapid communication is the warnings sent over the radio about hurricanes. It makes it possible for many to prepare for them and to save much property from serious damage.

Means of Communication.—The commonest means of communication are the telegraph, the telephone, the cable, and the radio. We cannot enter into a lengthy discussion of the history of these, but we can give a brief account of their importance.

Telegraph.—The telegraph was invented by F. B. Morse before the Civil War. It proved of great value in that war. After the war, the growth of telegraphy was very rapid. New inventions increased its usefulness and reduced the cost of sending messages. But the telegraph soon came into competition with the long-distance telephone and wireless telegraphy.

Telephone and Teletype.—The telephone was invented in 1876, and its use has spread rapidly. There are now millions of telephones in use in the United States, and hardly a place exists that cannot be reached by a phone call. Business would find it difficult and inconvenient to function without the telephone. In 1930 teletyping was perfected. By means of the teletype, typewritten

messages can be automatically reproduced. This has been a great aid to business and to police.

Radio.—Probably the most outstanding of all recent inventions in the field of communications is the radio. It was first established between 1920 and 1922 as a regular means of public entertainment in the United States. Radio has had its greatest period of development

since the First World War. In 1920 the first regular broadcasting service in our country was established by station KDKA. In 1926 the National Broadcasting Company was established, followed the next year by the Columbia Broadcasting Company. These are still the two largest broadcasting systems although there are several other systems that render valuable service. By 1935 radio had become a major industry. Its services during the Second World War were incalculable, especially for our armed forces.

Radio has affected intimately the everyday life of practically every person in the United States. Few homes are without a radio set, and it is hard to think of life without one. By means of news broadcasts, weather reports, market quotations, musical programs, lectures, sports' reports, and discussion of current topics, radio has become a vital factor in influencing our economic, political, and social thinking and activities.



Wide World Photo

THE AUTOMATIC TRANSMIT-TER—Sending a telegram will be as simple as dropping a letter in a mailbox. This machine, called a "Telefax," sends messages automatically so that the receiver gets a facsimile copy of the original telegram.

### Regulation of Communications.

All the modern means of communications cross state and national lines and thus have become serious problems. We have learned that it was necessary to place the means of transportation under the control of a governmental agency, the Interstate Commerce Commission. So it soon became evident that some such treatment would have to be applied to communications. However, radio first called attention to the need of control. In 1927, the Federal Radio Commission was set up with authority to control radio. In 1934, this commission was replaced by a new commission known as the *Federal Communications Commission*. This new commission was given control over telegraph, telephone, cable, and radio communications. It has power to grant licenses and to revoke them for cause; to grant or withhold permission to extend lines and

areas of communication; to fix wave lengths, power, and hours of operation of radio stations; and to do many other things. In short, interstate communications are now regulated in much the same way that means of transportation are regulated.

Summary.—Transportation is one of the most essential features of modern economic life, for without it our daily lives would be decidedly different and we should suffer great inconvenience.

Transportation in the United States has developed from crude trails to the great transcontinental railway systems and many-laned highways of today. Of all modern forms of transportation, many consider the railroad the most essential. Our railroads have passed through many phases with governmental regulation occupying a prominent place. They have had to meet competition from busses, trucks, private automobiles, and airplanes. When war came, the railroads were a dependable means of transporting war materials and troops. Though they are heavily in debt to the government, they may be able to regain their former leadership because of the added revenue gained from these war activities.

Our merchant marine has also passed through many phases but now seems on the way to becoming the largest in the world.

Not only is an adequate system of transportation necessary to the efficient functioning of modern life, but a good system of communications is equally necessary. This has been developed in the United States along with the growth and development of industries. One has kept pace with the other. Today we have the telegraph, the telephone, the teletype, the wireless telegraph, the cable, and the radio. Of these the radio is probably the most marvelous invention of them all and occupies a vital place in our modern life.

#### Questions to Test Your Knowledge

- 1. Show that transportation is of great importance today.
- 2. Outline the development of our railroads.
- 3. In what ways do railroads differ from other kinds of business?
- 4. Explain what is meant by charging all the traffic will bear.
- 5. List the unfair practices to which railroads resorted.
- 6. What is meant by rebating? Give an example.
- 7. State the chief provisions of the Interstate Commerce Act.

- 8. List some of the things railroads have done to meet the competition of busses and trucks.
- 9. What advantages have motor trucks and busses over railroads?
- 10. Trace the history of our merchant marine.
- 11. Name the chief means of communications used today.
- 12. Give several examples of how the radio performs a vital function in modern life.

#### Questions for Discussion and Application

- 1. Mention several commodities in the production of which transportation is the chief factor. Are there any commodities in the production of which transportation plays little, if any, part?
- 2. When a retailer finds that he is losing money, he may close out his business or sell it. When a railroad finds that it cannot meet its interest charges from its current earnings, why can it not do as the retailer does?
- 3. Is it possible for a railroad to figure out with any degree of exactness the cost of carrying one pound of freight or one passenger for any distance? Explain.
- 4. Show by several examples that the railroads are closely tied up with the prosperity of the country. What bearing does this have on the matter of government regulation?
- 5. Summarize briefly the recent legislation affecting transportation. Which of these acts will probably improve the services to the public?
- 6. Discuss the services rendered during the Second World War by our railroads and by our merchant marine.

#### Floor Talks and Written Reports

- 1. Future of railroad transportation.
- 2. Government control of railroads.
- 3. The ship subsidy.

#### Topic for Debate

RESOLVED, That government ownership and operation of railroads provide the only fair solution of the railroad problem.

### For Further Information

Bogart, E. L., "Economic History of American People," Chaps. XIII, XXIV.

Building America, "Transportation," Vol. I, No. 4.

Faulkner, H. U., "American Economic History," Chaps. 14, 23, 30.

McGrane, R. C., "Economic Development of the American Nation," Chap. 22.

Moulton, H. G., and Associates, "The American Transportation Problem." Patterson, S. H., and W. K. H. Scholz, "Economic Problems of Modern Life," Chaps. XXIV, XXV.

# Chapter XXVI

# How and Why Labor Organizes

#### Aims of This Chapter:

To learn why labor has organized into groups.

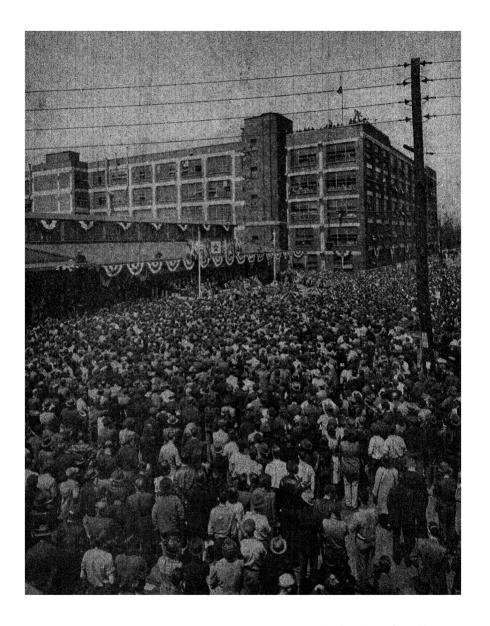
To study the various types of labor organizations.

To examine the causes of disputes among labor organizations.

To learn the advantages and disadvantages of labor unions.

THUS far in our study you have learned something about the kinds **L** of labor and the means by which the worker may increase his efficiency and earning power. You have also found that the capitalist, who is usually the employer of large numbers of workers, wishes to increase his output in order that he may earn greater profits. He has developed the system of division of labor and has speeded up production through the introduction of machinery and new methods of manufacturing. Although these methods have increased output and reduced the price of many articles to consumers, the workers themselves have felt that their interests were not always given the consideration that was called for. They soon found that, where there were large numbers of workers employed in the same plant, the individual worker had little chance to improve his working conditions or to obtain higher wages. This fact has led workers to organize into groups so that they might have a better opportunity to bargain for what they want. In this chapter you will learn why workers have organized and how they have gone about it. You will see how the organization of capital has been accompanied by the organization of labor. You will find that big business has been challenged by powerful labor organizations; you will discover capitalistic monopolies matched by labor monopolies.

Why Have Workers Organized into Groups?—In addition to the reasons given above, there are several other reasons why workers have found it necessary to combine their interests in some form of



Courtesy of Delco-Remy Division, General Motors Corporation

WORKERS IN BIG ORGANIZATIONS—This picture gives an idea of the great number of workers employed in present-day corporations. Here crowds of the employees mass in front of one of the Delco-Remy plants for a War Bond rally. group activity. In this book it will not be possible to discuss all these reasons, but the two most important ones can be explained.

Change in Type of Business Organization.—Before 1865 most businesses were owned and managed by individuals or partnerships. These were usually small and were characterized by a fairly close personal relationship between employer and the employees. There were few labor problems, and the individual worker felt free to approach his employer and to bargain directly with him. So long as the employer was a reasonable man and discussed matters openly with his employees, there was little friction; loyalty to the firm was characteristic of most of the workers.

After 1865 a change came about in the form of business organization. Although there are still many businesses that employ a few workers and where the relations are still pleasant, by far the larger number of workers today are employed by corporations. As you have learned, corporations are rather impersonal in their relations with employees and the workers have little chance to see the "boss." In fact, they seldom know who the boss really is. In trying to bargain with the officials of the corporation, the individual worker finds himself at a decided disadvantage. The corporation cares little about any one worker for he can usually be replaced easily if he is dissatisfied. But since labor is the only product that the worker has to offer if he is to live, the job becomes essential to him. If he loses his job or fails to obtain what he considers fair wages, his family suffers. The individual worker in a corporation is a poor bargainer; if he is to better his conditions, he must unite with other workers. Thus the change from individually owned business to corporations has brought the worker to a realization that his efforts to better himself will succeed only through some form of group action. Hence, unions became necessary.

No More Free Land.—Although the connection between free land and labor unions may seem remote, the fact that there once existed an abundance of such land had a great deal to do with the formation of the first unions. The United States came into the possession of large tracts of territory in the West; this land the government wished to develop and to make productive. Settlers were induced to go west through the offer of many acres at a very low price.

In 1862, Congress passed the Homestead Act, which gave land to all who would go west and cultivate it. This was a great boon to workers who were dissatisfied with their working conditions and who saw no way to improve these conditions. The dissatisfied worker did not think of uniting with others as long as he could pack up and go west to become an independent landowner. He gave up his job and went west.

By 1890 practically all of this free land was either taken or sold by the government to speculators. The dissatisfied worker could no longer quit his job for he had no chance to go west and become independent. So he stayed on his job and joined with others in groups to gain better working conditions.

What Were Early Labor Organizations Like?—You should not think that early labor unions were exactly like those of today. There were at first no national unions and each union acted according to its own regulations. It was only natural that those who worked in the same trade or craft in the same community joined together. The first of this type of union was set up in 1792 in Philadelphia. Other local trade-unions in other cities followed during the first quarter of the nineteenth century. They were all of the *local trade-union* type, composed of workers in a certain craft in a certain city.

Local Federations.—The next step was the organization of district federations composed of the local trade-unions in certain parts of the country. The members of these federations did not seem to have any serious grievances against employers as such but were concerned about the merchants, bankers, and others whose interests were financial rather than industrial. Their program included a demand for a ten-hour day, more leisure, and educational opportunities for their children.

National Trade-unions.—After the formation of local or district federations, it was a natural step to organize these into a national trade-union. After the Civil War, when railroads were being built and big business was developing, there was a great demand for labor of all kinds, especially skilled labor. This led to the formation of national labor unions to enable workers to maintain their rights and to gain better wages. National labor unions were organizations of the workers in a given trade over the entire country. By the end of the sixties there were many national trade-unions in existence. These unions flourished until the depression of 1873–1879 caused them to disappear.

Knights of Labor.—The outstanding labor organization of this period was the Knights of Labor. This was a national union which

started as a secret society in Philadelphia in 1869 among a group of garment workers who were dissatisfied with the exclusive craft unions and who wished to have one big union. For a time it combined all types of labor, skilled and unskilled, men and women, whites and colored, in one mighty association. It excluded from membership lawyers, bankers, stock brokers, gamblers, and bartenders, because they considered these to be parasites and not laborers.

The Knights of Labor demanded the eight-hour day, income and inheritance taxes, postal savings banks, payment for injuries caused by industrial accidents, and governmental ownership of railroads and other public utilities. They also favored producers' and consumers cooperatives.

In 1886, the Knights of Labor claimed a million members. However, differences of opinion began to develop in their ranks and it was thought best to abandon the political methods that they had used. Radical leaders gained control, and more strenuous methods were used. A series of strikes occurred, some of which were successful but most of which failed. Finally, many of their influential members joined the newly organized American Federation of Labor (AFL); the Knights as a labor organization lost influence and passed out of the picture.

American Federation of Labor.—This was formed in 1881. It is a rather loose group of national and international unions, together with local unions, craft unions, and semi-industrial unions. Several large industrial unions have become members, but the national craft unions make up the main support of the Federation.

Individual membership is indirect. Federation members are members of local unions which are directly or indirectly affiliated with the Federation. Each national union retains the right to charter its own local unions, to carry on strikes, and to arrange wage schedules. The Federation grants charters to each national or international union. That field is known as the union's "jurisdiction." The unions are forbidden to trespass on the jurisdiction of another union. The lines of distinction are not always clearly drawn, and jurisdictional strikes are common.

The central association, the Federation, has certain functions which it performs. Among these are helping to form other craft unions, local and national; watching over the legislative interests of all unions; lending such aid as may be possible to any member union engaged in a labor dispute. Until 1924, Samuel Gompers was its



Wide World Photo

AN AFL CHARTER—The AFL charters all unions that are affiliated with it. Here the President of the Auto Workers of America and the President of the AFL are examining the charter which has just been granted to the AWA.

president. Under his leadership its membership grew rapidly and its influence became powerful in all labor matters.

During the First World War the Federation cooperated with the government and thereby gained in public approval. Its membership doubled. After the war its membership declined. In 1924 Gompers died and was succeeded by William Green. During the great depression of the early 1930's, the Federation lost many members and much influence, owing to the great amount of unemployment. After 1933, aided by favorable labor legislation and improved business, it again gained strength; its membership reached a new high in 1940.

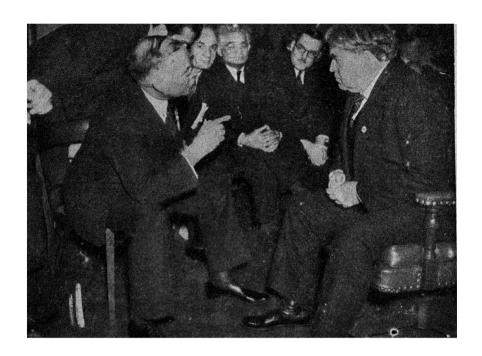
What Are Industrial Unions?—The AFL is made up almost entirely of craft or trade-unions composed of skilled workers. At the time the Federation was formed, the skilled workers predominated. Each worker could perform all the operations in the production of any particular article. This is the type of worker described by the term "craft." But with mechanization, standardization, and large-

scale production, conditions changed. Industry was reorganized and division of labor was introduced. Now, instead of performing all the operations in the production of an article, the worker performed only one task or operation. Skilled occupations were broken up into specialized operations, whether they were performed by machine or by hand. Mass production with the belt and the conveyer has placed more emphasis on speed and quantity than upon craftsmanship.

This new type of production gave rise to a new problem of labor organization; the formation of industrial unions. An industrial union is one that includes all workers in a plant, skilled, semiskilled, and unskilled. It is a type differing from the AFL in that it combines the workers on the basis of their industrial connection, rather than on the basis of their skill. It includes the unskilled workers in the industry, whereas the Federation does not. The industrial union differs from the labor union in that it confines itself to the workers of a single industry. It may be called a vertical combination of workers, in comparison with the Federation, which is a horizontal combination of skilled workers. It is represented by the Congress of Industrial Organizations, to be described later.

Which Type of Union Shall Predominate?—With the two types of unionism prevailing at the present time, craft and industrial, there was bound to be a dispute as to which should prevail. For many years there has been a discussion regarding the relative merits of the craft union and the industrial union. Those who favor industrial unions claim that they have the only form of organization that can successfully oppose the corporation and that labor must unite and organize on a large scale just as industry does. The claim is made that only through industrial unions can labor hope to achieve the place it deserves in our national economy. Supporters of the industrial union also maintain that members of craft unions are in a minority in mass-production plants and therefore do not represent the workers as a whole. The supporters of the craft unions deny all these claims and assert that the interests of labor are better protected by skilled workers than by the unskilled.

The issue between the two types came to a head at the 1934 convention of the AFL. At this convention it was decided to form industrial unions in the automobile, cement, and aluminum industries. But when the 1935 convention met, the supporters of the industrial union idea felt that the charter that had been granted to the automobile workers was not an industrial union charter at all. This led



Press Association, Inc.

CIO or AFL?—President William Green of the American Federation of Labor is trying to persuade John L. Lewis, founder of the CIO, not to leave the AFL. Was he successful?

to a heated discussion, with John L. Lewis championing the idea of the industrial unions. When a vote was taken, the craft unionists won by a large majority and reaffirmed their belief that craft unions were the most effective means of protecting the workers. Lewis, thereupon, resigned from the executive council of the Federation and, with the help of the leaders of seven other unions who favored industrial unionism, formed the Committee for Industrial Organization and opened an office in Washington to carry on the campaign for industrial unionism. The AFL ordered the committee to disband but it refused to do so. Then the Federation expelled the eight unions from membership, and a bitter struggle began to control organized labor and to determine what policies would be most beneficial to all workers.

Congress of Industrial Organization (CIO).—In 1938 the name of the Committee for Industrial Organization was changed to the Congress of Industrial Organizations, better known as the CIO. It



Courtesy of CIO

A LABOR LEADER—Above is a photograph of Philip Murray, who was elected president of the CIO in November, 1940.

thus became to all intents and purposes a separate national labor organization in competition with the Federation. It was organized by John L. Lewis who was its leader until 1941, when Philip Murray took his place. The CIO is dedicated to the task of organizing the mass-production industries on industrial lines and to eliminating jurisdictional disputes.

Since the formation of the CIO there has been a great growth in the membership of labor organizations. Progress is steadily being made by the CIO in organizing mass-production industries, and each new industry means a big increase in membership. However, the struggle between the CIO and the AFL continues.

Why Are Company Unions Formed?—Another type of union is the so-called "company" union. This is a union composed of the workers in a certain factory; it is not connected with one of the national unions or with the general and independent labor movement. It comes into being with the full consent of the employer. In a company union the workers elect their own representatives from among their number to meet at stated times with representatives appointed by the employer. For this reason company unions are sometimes known as "employee representation committees."

Since the representatives depend for their jobs upon the management with which they deal, they tend to be less independent and vigorous in working for the interests of the workers than an independent representative might be. Their bargaining power is much less than that of an outside union.

The company union has been successful in improving labor relations in some cases, but in many others it has failed to do so. Organized labor does not like the company union because it is regarded as an attempt to prevent workers from joining regular unions.

In 1935, the National Labor Relations Act made it unlawful for an employer "to dominate or interfere with the formation of any labor organization or contribute financial support to it." This provision does not eliminate all company unions but only those which are dominated by the company.

How Are Labor Unions Beneficial?—Several advantages to workers' membership in a strong union have been claimed. Only a few can be listed here. If you talk with a member of a union, you will be able to learn others.

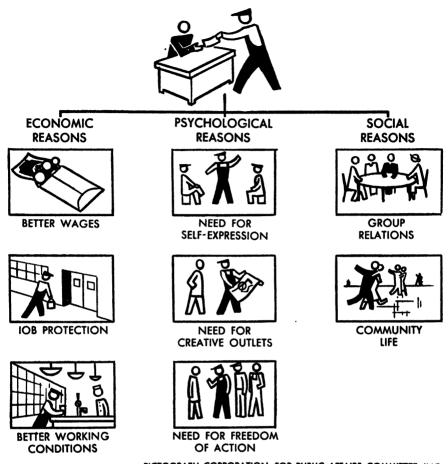
Union Members Often Receive Higher Wages Than Nonunion Members. Members of a union usually work under some sort of agreement whereby they receive a stated hourly rate and are not bound to work for less. This rate is usually much higher than is paid to those who do not belong to unions because the union through collective bargaining is strong enough to force the payment of higher wages.

Unions Have Brought Shorter Hours and Better Working Conditions.— Owing to the effectiveness of organized labor, much has been done through the years to force employers to reduce the hours of employment per day and to make factories safer and better places in which to work. Protection against accidents, better lighting and ventilation, rest periods, and compensation for accidents, have all been brought about through the efforts of unions. The Wages and Hours Law and the National Labor Relations Act, which have meant so much to labor, were made possible because of the insistence and interest of unions.

Unions Make for Strength.—A strong union is in a better position to demand and obtain changes that will benefit the workers than is an individual. When a strike occurs, all the members of the union act together to help others. Their organization and their funds enable them to meet the employer on a more equal footing and to force concessions. Since local unions are affiliated with national organizations, they can usually call upon the larger and stronger organizations to assist them.

Unions Benefit Members in Various Ways.—In addition to the economic gains from union membership, there are many social advantages. Some unions conduct educational programs for members. Many unions publish a paper or a monthly magazine which provides information about union activities as well as material of an entertaining and instructive nature. Several of the larger unions have a system of death, sickness, and funeral benefits. In addition some of the larger

#### WHY WORKERS JOIN A UNION



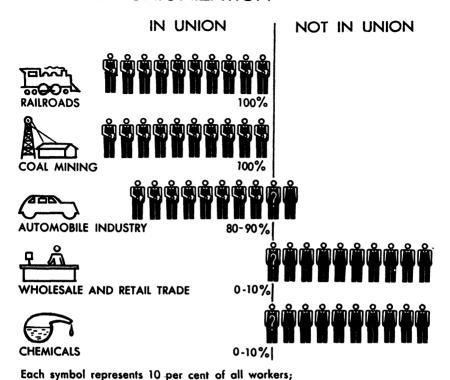
PICTOGRAPH CORPORATION, FOR PUBLIC AFFAIRS COMMITTEE, INC.

unions maintain homes for aged members and operate insurance companies for members and their families.

Criticisms of Labor Unions.—Labor unions have not been free from criticism by the public and by those who are opposed to unionism. In spite of the many benefits that union members enjoy, it has been claimed that unions are not always what they seem. We shall state a few of these criticisms.

They Are Accused of Resorting to Unfair Methods.—It is claimed that in dealing with employers labor leaders use unfair methods to gain their ends. It is also claimed that union members are unfair to those

## ESTIMATED UNIONIZATION



question mark indicates doubtful classifications
SOURCE: Twentieth Century Fund, Inc., Data 1940-42

PICTOGRAPH CORPORATION, FOR PUBLIC AFFAIRS COMMITTEE, INC.

who do not choose to belong to the union and refuse to work beside a nonunion man. This often results in the discharge of the nonunion worker. It is further claimed that unions bring pressure to bear upon workers to join their union.

They Are Accused of Resorting to Violence in Strikes.—This criticism is heard when there is a bitter or prolonged strike in an industry. To prevent other workers from taking their places, the strikers resort to picketing. Picketing in itself is not considered unfair but when those on picket duty use strong-arm methods or resort to physical violence to prevent others from entering the plant, many complaints are made against the union methods. It is also charged that unions sometimes damage machinery or products in a way hard to detect and thus cause unnecessary loss.

They Sometimes Add to Labor Costs.—It is claimed that the regulations of some unions are such that a job is needlessly prolonged by the workers who perform only a limited amount of work a day and thus make the job cost more.

They Are Accused of Calling Unnecessary Strikes.—This criticism has arisen chiefly because of what is known as the "jurisdictional" strike. This is not a strike against the employer but a disagreement within the ranks of the unions as to who shall perform certain tasks. While the dispute is in progress, the employer and public suffer. During the Second World War there developed a strong feeling that unions had called several strikes in war plants for insufficient reasons in spite of their agreement not to strike during the war.

Summary.—When business was carried on through individual ownership or partnerships, labor troubles were rare. But with the rise of corporations it became more difficult for the worker to bargain with his employer. Coupled with this was the loss of a strong bargaining point when the worker could no longer give up his job if dissatisfied and go west to become independent by taking up some free land. These factors, among others, led workers to join with one another in what came to be known as unions.

Labor organizations at first were small local trade-unions confined to those who were engaged in the same craft in the same community. Later these local unions joined with similar unions of other localities to form a local or district federation. From these district federations developed the national trade-unions.

The earliest of these national unions, the Knights of Labor, was an attempt to form one big union made up of practically all workers whether skilled or not. It was succeeded by the American Federation of Labor in 1881. This is a loose federation of craft unions, based upon the principle that craft unionism is the best method of gaining better conditions for labor.

But there was a question in the minds of many labor leaders as to whether craft unionism was the best way to gain what labor wanted. One group felt that only through adopting the methods used by corporations could labor hope to survive. These leaders believed in the industrial union idea. They would unite all the workers in an industry, whether skilled or unskilled, to bargain collectively with the employers. This difference of opinion caused a split in the ranks of organized labor, as a result of which a new national

organization was founded. This was called the Congress of Industrial Organizations.

Unions have brought about many changes for the better in working conditions, wages, hours of work, and bargaining ability. They have brought to workers many advantages which they could never have obtained single-handed. However, labor unions have been severely criticized because of their method of conducting strikes, their attitude towards nonunion workers, and because of the attitude and conduct of certain leaders.

#### Questions to Test Your Knowledge

- 1. List several reasons why workers have formed labor unions.
- 2. Why are relations between employers and employees in a corporation called impersonal?
- 3. Describe the organization and program of local trade-unions.
- 4. Explain the organization of the Knights of Labor. What was its program?
- 5. How is the American Federation of Labor organized?
- 6. What are the functions of the American Federation of Labor?
- 7. How does a craft union differ from an industrial union?
- 8. What is a company union? How is it formed and financed? What is its chief weakness?
- 9. What is the chief cause of the quarrel between the American Federation of Labor and the Congress of Industrial Organizations?
- 10. How does the Congress of Industrial Organizations differ in its organization from the organization of the American Federation of Labor?
- 11. List several advantages of membership in a labor union.
- 12. What are some of the criticisms made of labor unions?

## Questions for Discussion and Application

- 1. Are the laboring groups of today any better off than they were before the industrial revolution? Give reasons for your answer.
- 2. Show how the disappearance of free land affected the ability of the American worker to bargain with his employer.
- 3. Explain how the organization and growth of corporations influenced the development of labor unions.
- 4. Why has craft unionism so long been the dominant type of labor organization in the United States? What opposition to this type of unionism has arisen during the past decade or two?

- 5. What changes in industry have tended to weaken craft unions? What may this mean for this type of union in the future?
- 6. Can you think of any basis upon which courts can declare company unions illegal? Has the United States Supreme Court ever handed down a decision for or against company unions?

#### Floor Talks and Written Reports

- 1. Case for and against company unions.
- 2. The decline of craftsmanship.
- 3. Craft unions vs. industrial unions.

#### Topic for Debate

RESOLVED, That the industrial union is better suited to care for the needs of labor than the craft union (or vise versa)

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#### PROBLEM 31

#### Craft Union or Industrial Union?

The skilled workers in a manufacturing plant in an Eastern city had been members of a company union for several years. Several of the leading members had come to the conclusion that such an organization could not obtain for them the advantages they desired. The unskilled workers in the plant had not been too friendly because they were excluded from the union. After much comment and discussion, it was decided to ask the representatives from the AFL and the CIO to meet with them and discuss the advantages of each type of organization. After these representatives had expressed their views, all the workers in the plant were asked to vote their preference: whether to organize on a craft basis or on an industrial union basis.

- 1. What are the advantages of company unions:
- 2. State several disadvantages of this type of union.
- 3. How does a craft union differ from an industrial union?
- 4. What advantages could the advocates of industrial unionism offer in favor of their type of union?
- 5. What advantages could the craft unionists offer?
- 6. If you had been a worker in this plant, how would you have voted? Give full reasons for your answers.

# Chapter XXVII

# Aims and Methods of Labor Unions

#### Aims of This Chapter:

To learn what labor wants and why.

To discuss the policies of labor unions.

To examine the methods used by labor unions.

You have learned why and how workers organize and have examined some of the forms these unions take. You have also learned that a serious dispute is going on between the two largest national organizations of labor. We turn now from the conflict within the ranks of labor to the policies of these unions and to the methods used by the unions to gain their ends. It will be the purpose of this chapter to describe the aims of organized labor and to discuss the struggle to obtain their demands.

What Does Organized Labor Want?—Labor has been struggling for many years to obtain what it has called its "rights." Among the objects it has been striving to gain are the following:

Higher Wages, Shorter Hours, and Better Working Conditions.—One of the main purposes of forming unions is to obtain higher wages for the members. Back of this desire for better wages is the desire to maintain or to raise the standard of living of the workers. Along with a demand for higher wages comes that for shorter hours; these two aims are often associated. Improved working conditions are sought so that workers may carry on their employment in safety and comfort. If workers can have higher wages, shorter hours, and better working conditions, the unions believe that they will become more efficient; thus employers as well as workers will be the gainers.

What Is Collective Bargaining?—This was the primary purpose in forming unions. Without it they could not continue. Collective bar-

gaining exists when the organized employees of an industry, through their own chosen agents, make an agreement with the employer which binds both parties. These understandings, called trade agreements, include terms regulating wages, hours, and conditions of work.

What Are the Essentials of Collective Bargaining?—If collective bargaining is to be successful and effective, two conditions are essential. One of these is that there must be a strong and effective labor organization. The more effective the control of labor leaders over their organizations, and the stronger and wiser this leadership is, the greater is the likelihood that the rank and file of the members will accept and abide by the terms of the agreement made by their representatives. Thus the first essential to successful collective bargaining is a strong and wisely managed union.

The second essential is that the union must be recognized by the employers, because the organized group deals through its officers, or other representatives, not as separate individuals but as a unit. Although some employers have long refused to deal with a union of any kind except their own company union, leaders of labor are convinced that only through the recognition of a responsible bargaining agency, the union, can there be any effective bargaining. This is the main reason that labor leaders insist upon the closed shop, which will be explained later.

Collective Bargaining Is Legally Recognized.—The struggle for the right of collective bargaining has been a long and bitter one. Although many open-minded employers have bargained collectively with their employees, it was not until 1933 that labor succeeded in having its right to bargain collectively established by law. This was accomplished through Section 7a of the National Industrial Recovery Act (NIRA) which stated, "that employees shall have the right to organize and bargain collectively through representatives of their own choosing, and shall be free from interference, restraint, or coercion of employers of labor, or their agents, in the designation of such representatives or in self-organization or in other concerted activities for the purpose of collective bargaining or other mutual aid or protection." Although this section became effective only when it was written into codes of fair competition, under the National Recovery Administration it had the force of law when these codes were approved by the President. It was considered a great victory for labor. But the immediate victory was short-lived because the United



Wide World Photo

EMPLOYEES VOTE ON BARGAINING REPRESENTATION—The National Labor Relations Board of Detroit takes charge of the polling at which Packard workers cast a secret ballot to determine who is to represent them in collective bargaining.

States Supreme Court in a unanimous decision in 1935 declared that section of the NIRA relating to code making unconstitutional.

The National Labor Relations Act (Wagner-Connery Act) was passed the same year that the NIRA was declared unconstitutional. It reaffirmed and emphasized the whole principle of collective bargaining. It also created the National Labor Relations Board (NLRB) to enforce the right to bargain collectively. The act says, "Employees shall have the right to self-organization, to form, join, or assist labor organizations, to bargain collectively through representatives of their own choosing, and to engage in concerted activities, for the purpose of collective bargaining or other mutual aid or protection." The Supreme Court declared this act constitutional in 1937. Since then the NLRB has made many decisions which have cemented the right of collective bargaining. Thus labor's right to collective bargaining has been firmly established in law.

Labor Wants a Closed or Union Shop.—Organized labor insists upon the closed or union shop in order to enforce collective bargaining. Many employers insist upon the open shop. Strictly speaking, an open shop is one in which the employer is free to hire anyone he chooses whether he belongs to a union or not. The practical effect

of this is that an open shop frequently becomes a shop in which no union member is employed. When a closed shop is mentioned, what is meant is a shop that is closed through the efforts of the unions rather than of the employer.

Two Forms of Closed Shop.—There are really two kinds of closed shops: (1) the one with the open union, in which nonunion men may find employment but only on condition that they join the union; and (2) the one with the closed union, in which only persons already members of a union may be employed. Organized labor prefers the latter.

Arguments for Closed Shop.—The unions favor the closed or union shop for the following reasons: (1) Collective bargaining can be more effectively maintained in such a shop. (2) It is unfair for nonunion workers to obtain the higher wages, shorter hours, paid vacations, and other conditions which the unions have won through hard struggles and the payment of union dues, when the nonunion workers have contributed nothing to the struggle. (3) The closed shop aids the employer by furnishing him with a more efficient labor supply. Unions maintain that no shop can operate efficiently that employs both union and nonunion workers. (4) The closed union shop makes it possible for a strike to be more effective.

Arguments against Closed Shop.—Many employers who are willing to bargain collectively with their employees offer serious objections to the principle of the closed shop. They claim that the open shop is more American and democratic in that it offers every man, regardless of whether he belongs to a union or not, a chance to work when work is available. They also claim that the closed shop results in friction because outside labor leaders meddle in affairs about which they have no knowledge. This is one reason company unions have been favored. The employers object to the closed shop for another reason. They claim that the closed shop, if strictly enforced, prevents the employer from exercising any freedom in hiring or firing men. Their claim is that the labor union exercises a monopoly in the shop. Finally, employers claim that strikes that reduce production are more likely to occur in a closed shop than in an open shop.

Labor Demands the "Checkoff" and "Maintenance of Union Membership."—Unions often demand that, in agreements drawn up between the union and the employers, the employer must agree

to deduct from the pay of each union member the amount of his union dues and pay these over to the union officials. This "checkoff" plan makes the employer a collector of dues for the union. Employers object on the ground that the payment of dues is a personal matter for the worker to decide for himself.

Unions, especially those affiliated with the Congress of Industrial Organizations, have demanded a clause in the contract which binds the employer to discharge any worker who fails to pay union dues or to maintain good standing in the union. This is to be done whether the employer has any complaint against the worker or not. This is, in effect, a somewhat more drastic form of the "checkoff."

How Do Unions Obtain Their Demands?—Although labor looks upon the above demands as reasonable, employers have not agreed with them in all cases. It has not always been possible to settle differences between workers and employers through mere argument and persuasion. Other means have often been used.

Strikes.—This is the most important of labor's weapons. A strike is the voluntary stopping of work by a group of workers for the purpose of enforcing certain demands or of securing certain concessions from the employer. The strikers consider that the job still belongs to them. They intend to resume the job again as soon as they have won their demands.

The *direct* strike is one where those who strike have a grievance against their employer. When the bus drivers' union in a city carries on a strike against the bus company, it is a direct strike.

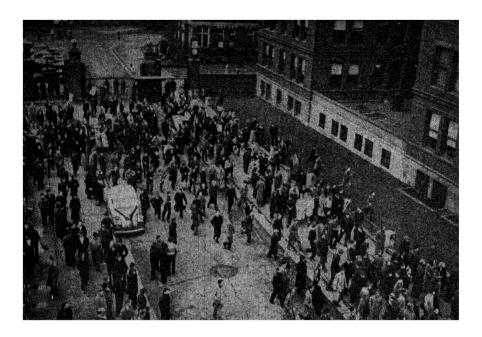
A sympathetic strike is one where workers in other crafts or industries, generally located in the same community, go out on strike at the same time. They do so in order to aid their fellow workers who are striking in a plant with which the sympathetic strikers have no direct relations.

The general strike represents stoppage of work in all industries in a region or a nation.

The *jurisdictional* strike grows out of disputes between rival unions. An example would be a dispute between plumbers and steam fitters as to who should install the boilers in a hotel kitchen.

Strikes of workers have been called *walkouts* in contrast to *lockouts* by employers. In one case, the workers leave the plant; in the other case, they are kept out of the plant. In neither case are they in the plant.

The sit-down strike is one in which the employees sit down at their



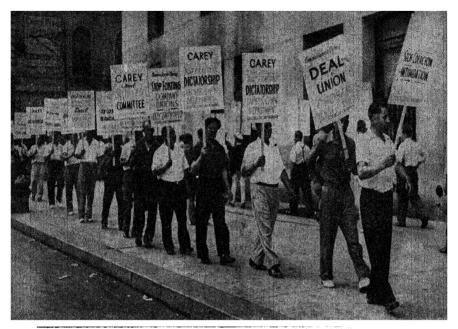
Wide World Photo

STRIKERS CLASH WITH POLICE—As this picture was taken, police in the background were dispersing strikers rioting at the main gate of their plant. Strikes often cause violence and consequent police intervention.

machines to prevent others from taking their jobs. In February, 1939, the United States Supreme Court declared the sit-down strike illegal. The sit-down strike was then succeeded by the *slow-down* strike. Employees went to work but at a reduced speed.

Strikes usually result in inconvenience and expense to the employees, the employers, and the public. A strike seldom decides the right or wrong of an issue; it merely determines for the moment which side is the stronger. Hence, there has been some question as to whether strikes should be permitted. Under the common law strikes for the purpose of improving working conditions are considered lawful. But if the strike is for the purpose of injuring the employer, it is considered unlawful.

Boycott.—A boycott is an attempt by striking workers to hurt their employers by inducing customers not to do business with them. When the striking workers merely refuse to purchase the products of their employers, it is called a primary boycott. These are not very effective. The secondary boycott is much more effective. This occurs when workers in the same trade or industry refuse to work on products made by an employer who refuses to recognize a union in his plant.



Wide World Photo

PICKETERS—The workers above are picketing in protest against the refusal of their employer to meet with representatives of their union. Peaceful picketing, which involves no acts of violence, is legal.

Thus, if a strike in a single plant occurs, workers in other plants, often in other communities, will refuse to handle or to work on the products of the plant where the strike is going on.

Picketing.—In order to make sure that a strike will succeed, members of a striking union must prevent others from coming in and taking their jobs. To do this they resort to what is known as "picketing." Some of the strikers, called "pickets," take their stand at the workers' entrance to the plant and try to persuade any regular employees who have not joined the strike and any new employees, called "strikebreakers," from taking their jobs. When the strikebreakers refuse to be scared off, violence often results and much damage may be done. Union members call those who attempt to break strikes, or to work under conditions not acceptable to the unions, "scabs." The courts usually consider picketing legal if it does not result in acts of violence on the part of the strikers and if those who wish to work are not frightened off by the threats.

Summary.—In their efforts to obtain higher wages, shorter hours, and better working conditions, union labor has met with the

opposition of employers who do not look kindly upon unions and their aims. Organized labor has struggled for collective bargaining; it finally succeeded in having this principle established by law in the National Labor Relations Act. Unions desire the closed shop in order to make collective bargaining more effective and to discipline and direct their members to greater advantage.

It has not always been possible to settle labor disputes in a peaceful manner. It has been necessary at times to resort to the strike and the boycott. Strikes are of many kinds but all have the same purpose: to win for the unions the demands that employers will not grant through peaceful means. Boycotts are not very effective unless the secondary boycott is used. This may prove effective, but some courts have declared it to be against the antitrust laws in that it is considered a restraint of trade.

#### Questions to Test Your Knowledge

- 1. What are the chief aims of organized labor?
- 2. Explain what is meant by collective bargaining.
- 3. What conditions are essential if collective bargaining is to be successful?
- 4. Why is a strong union necessary for collective bargaining?
- 5. What is the difference between a closed shop and an open shop?
- 6. Why do unions so strongly favor the closed shop?
- 7. What reasons do employers give for opposing the closed shop?
- 8. List the methods used by labor to win their demands.
- 9. Define a strike. Name and explain several kinds of strikes.
- 10. What is a boycott?
- 11. Why is picketing used by labor?
- 12. Why is picketing sometimes objected to?

#### Questions for Discussion and Application

- 1. "Laborers organize to safeguard their standard of living and to ensure steady employment. They cannot, as a group, bargain effectively nor secure, maintain, and progressively improve their status in industry without the closed shop." Do you agree with this statement? Discuss its implications.
- 2. "The closed shop is an unjustifiable interference with the individual rights of the nonunion man." Is this true? Has the union any rights with which the nonunion man interferes? Discuss.

- 3. Do you consider it fair to demand that a worker must join a union in order to get and keep a job? Give your reasons.
- 4. The open shop is said to be more democratic than the closed shop. In what sense may this be true? Is the closed shop necessarily undemocratic? Discuss.
- 5. Direct strikes against immediate employers are often justified. What justification can you find for sympathetic strikes? for jurisdictional strikes?

#### Floor Talks and Written Reports

- 1. The struggle for collective bargaining.
- 2. The rights of employers.
- 3. What strikes can be justified?

#### Topic for Debate

RESOLVED, That the closed shop deprives a working man of his right to work where and how he pleases.

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#### PROBLEM 32

#### Closed Shop vs. Open Shop

The discussion as to whether an industrial plant should be operated on the basis of the open shop or of the closed shop has called forth much information relative to the rights of workingmen. Those who favor the open shop claim that it is the only type that leaves a workingman free to decide for himself whether he will join a union or not; that it is the American way; and that it does not interfere with the owner's management of his business. On the other hand, those who favor the closed shop deny that it is undemocratic or that it violates any American principles; they also deny that it interferes

in any way with the owner's conduct of his business. The growth of union strength during the recent war has caused many to believe that only union members will be able to obtain and hold jobs in the future.

- 1. Distinguish between an open shop and a closed shop.
- 2. May an open shop actually be a closed shop in some respects?
- 3. How does a closed shop restrict the employer's freedom in hiring and firing whom he pleases?
- 4. Is the closed shop a violation of a man's right to work under any conditions he chooses to accept?
- 5. If you were a worker which type of shop would you prefer? Give your reasons.

#### Chapter XXVIII

# Employers' Attitude—Settling Disputes

#### Aims of This Chapter:

To examine the methods used by employers.

To learn how disputes can be settled peacefully.

You have learned about the demands that organized labor makes and about the methods it uses to obtain these demands. Employers are not all in agreement with the demands of labor and have resorted to many methods of thwarting these demands. In this chapter we shall discuss the methods used. We shall also examine the various plans that have been tried to settle labor disputes in a peaceful manner.

How Do Employers Oppose Demands of Labor?—While organized labor has used one or more of the preceding weapons in attempts to enforce their demands, employers have discovered counterweapons of their own. Let us see what some of these are.

Lockout and Shutdown.—In order to meet the threat of a strike, employers frequently use the lockout. This means that the employer closes his plant and refuses to permit the workers to enter until they have come to terms. The employer does not actually discharge the men. He simply locks them out of the plant. The lockout, like the strike, puts an immediate stop to production and thus interferes with consumer ability to get the goods wanted. In both the strike and the lockout the employer has a distinct advantage in that he has the financial resources to hold out longer. In either case the employer loses money, but he is able to stand it better than the workers.

The effect of a shutdown is the same; namely, a closed plant and idle workers. But whereas a lockout implies an industrial conflict between employer and employees, a shutdown does not. It results from a lack of orders due to business depression.

Black List.—The employer may use another weapon which is more secret and difficult to combat. This is known as the "black list," which is a list of names of employees or former employees whom the employer regards as objectionable, usually because of union activities. These black lists are exchanged among employers through their associations. This means that any employee whose name is on the list will find it difficult, if not impossible, to obtain work with any companies that are members of the association. It may even mean that the black-listed employee cannot find work anywhere. It is really a boycott of workers.

The black list has been declared illegal in many states. But sometimes employers find a way of accomplishing their ends without resorting to it. When an employee is dismissed for some reason, he is given a clearance card to indicate that he has been honorably discharged. But in one corner of the card, or somewhere on it, there is a secret symbol which indicates to all members of the association that the worker is an undesirable person and should not be employed.

Injunction.—Employers have found that their strongest weapon to counterbalance the weapons of unions is the injunction. This is an order of a court which requires the person or persons to whom it is directed to do or refrain from doing certain acts. The injunction has been used in labor disputes in a variety of ways but almost always by the employer against the union. If the officials or other members of the union disobey a court injunction, they can be declared in contempt of court and fined or imprisoned or both. In using injunctions, employers have attempted to prevent both the strike itself and the picketing activities of the workers. They have sought, first, to obtain injunctions against the workers striking for any purpose. Second, they have sought to limit the kinds of picketing that workers might use.

In 1932, Congress enacted the Norris-LaGuardia Act, which covered all aspects of the issuance of injunctions by Federal courts. The act lists the situations in which a Federal court may not issue injunctions. If, however, workers use fraud or violence in their strike activities, a court may still issue an injunction restraining these activities in spite of the act. The act applies only to the Federal courts; but it has served as a model for many new state laws.

Yellow-dog Contracts.—In order to avoid labor troubles, some employers formerly followed the policy of having no union men in their employ. To make sure of this they compelled their employees to sign a contract agreeing not to join a union or have any relations

with unions while in their employ. Since this is considered a mean way of taking advantage of a man who wants to work, unions have called these "yellow-dog" contracts. It is not difficult to see how such an agreement can work against a union. In the contract is a clause which gives the employer the right to discharge an employee who violates the agreement by joining a union.

There has been much dispute regarding the legality of such contracts. Several states have laws which make these contracts legal. Other states have held that they were unconstitutional. The United States Supreme Court, by a divided opinion in each case, has apparently upheld the legality of these contracts, basing their decisions on the "freedom of contract" provisions of the Constitution. But organized labor has been bitterly opposed and has tried to have them outlawed. In 1932, through the Norris Act, Congress declared yellow-dog contracts illegal on all work done for the Federal government. In 1935, the National Labor Relations Act virtually put an end to such contracts.

Espionage.—A few employers who are strongly opposed to unions of any kind, except company unions, have adopted the practice of hiring men whose business it is to work with other employees, to join their unions, and in every way possible find out who the trouble-makers are. Employers claim that in this way they are able to discover who are the agitators and who are loyal workmen. Management can discharge those men who are too active in union plans or who are responsible for slowing down production or plotting destruction of materials or machinery, which is known as sabotage.

Can Labor Disputes Be Settled Peacefully?—Everyone is convinced that the settlement of labor disputes by direct action through strikes is costly and upsetting to industry and the country. In every strike of any importance the public suffers. Although workers may make some gains, it is doubtful if they are in proportion to the price paid. Level-headed leaders of both labor and industry have sought ways to settle differences without resorting to the strike. Collective bargaining is now an accepted practice; it is sanctioned by law. This means that there is a heavy responsibility resting upon both parties to settle their differences without using the weapons that have so long prevailed. Let us consider some of the peaceful methods of collective negotiation which can be used instead of the militant weapons of collective bargaining.

#### ARBITRATION



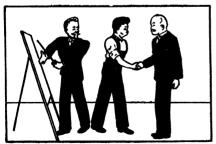
Worker and employer disagree.



Worker and employer submit to arbitration.



Arbitrator studies case and reaches decision.



Liulin Gawel

Worker and employer hear decision and are bound by it.

Arbitration of Disputes.—In baseball and other sports there is an umpire who settles all disputes; this decision is usually accepted even though there may be much wrangling over it. Many believe that the same method would work successfully in industrial disputes and should be tried more often. Arbitration is reference of a dispute to an outside party for settlement.

There are two kinds of arbitration: voluntary and compulsory. If the parties to the dispute are free to choose the umpire, it is called voluntary arbitration. But if both parties are obliged to submit their dispute to an outside agency and are forced to accept the decision, no matter what it is, it is compulsory arbitration. Unions do not like compulsory arbitration because they fear it will do away with the right to strike. Recently the Twentieth Century Fund appointed a committee on labor to investigate methods of arbitrating disputes in several countries. As a result of this study, it was declared that compulsory arbitration would not work successfully in a democracy. Voluntary arbitration is far better, even though it may not always be acceptable.

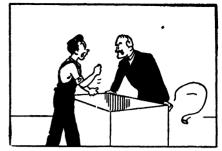
Conciliation and Mediation.— When voluntary mediation is used, every attempt is made to enable the parties to reach a settlement by voluntary agreement. It is essential that neither party be forced to accept a recommendation with which it does not agree and that neither party give up any of its fundamental rights. The mediator is called in only with the consent of both parties. His first task is to find out from each party the most that it will yield and the least that it will insist upon. He may then hold joint conferences or confer with each side separately; but he will try to get both parties to accept a plan that is worked out together in conference. In many cases this

In more than forty states there are now laws regarding the settlement of disputes by mediation; but, since the duties have been delegated to officials who are already overworked, not much has actually been accomplished. The Department of Labor has set up the United States Conciliation Service, which has a staff of about 100 conciliators. The staff is swamped with work and cannot give the attention to disputes that it should.

method has proved very successful.

In March, 1941, the President appointed a National Defense Mediation Board consisting of representatives of the public, of labor, and of employers. Cases were referred to this Board only after the regular processes of conciliation proved ineffective. When a dispute was certified to the Mediation Board by the Secretary

#### MEDIATION '



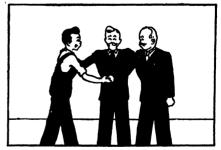
Worker and employer disagree.



Mediator hears both sides.



Mediator advises with employer and worker.



Frank Gawel

An agreement is reached.



Press Association, Inc.

INTERNATIONAL LABOR CONFERENCE—Labor unions of all countries are represented in the International Labor Office with headquarters in Geneva, Switzerland. Recently an ILO conference was held at Philadelphia. Here are some of the delegates.

of Labor, it named three persons representing the public, labor, and the employers, to deal with the case. It was authorized to do everything in its power to negotiate arrangements and to bring about voluntary arbitration. The Board tried to settle disputes before a strike had been called. It had some success and many hoped that the Board might lay the foundations for a better way to settle labor disputes.

The entrance of the United States into the Second World War called for more drastic measures. The National Defense Mediation Board was succeeded by the War Labor Board. Antistrike legislation was not passed, but labor leaders agreed not to call strikes for the duration of the war.

"Cooling-off" Period before Strikes Are Called.—It has been proposed that Congress pass a law requiring a delay before strikes or lockouts can be put into effect. The suggestion is made that this legislation follow the lines laid down in the Railway Disputes Act about which you learned in Chapter XXIV. As you will recall, this act requires a series of steps to permit investigation and report by outside agencies before a dispute turns into a strike. However, there are some who believe that conditions in industry are so different from those on railroads that such a plan will not prove effective.

What Does the National Labor Relations Act Provide?—Although this act has been mentioned several times in this text, it is necessary to bring it again to your attention because it has done more than any other act, except the Social Security Act, to make the

economic welfare of the worker more secure. The act has for its chief purpose to encourage collective bargaining and to guarantee workers the right to organize unions. But in addition it has definitely listed certain practices of employers as unfair to labor. These are (1) interfering with employees' rights, (2) interfering with the creation of labor unions, (3) discriminating against union members, (4) discharging employees for complaining of a violation of their rights, and (5) refusing to bargain collectively with representatives chosen by the employees. The National Labor Relations Board has become an influential agency in settling labor disputes and in guarding the welfare of workers. The act was held to be constitutional by the Supreme Court in 1937.

Summary.—Employers have sought to adopt measures to counteract the methods and weapons unions use to win their demands. For each of the weapons labor uses, employers have one of their own. Commonly used by them are the lockout, the injunction, the blacklist, espionage, and the yellow-dog contract. Thus a state of warfare has developed between the two groups, which should cooperate because neither of them can exist without the other. Industrial warfare is expensive to all concerned and actually accomplishes little that is permanent.

Sensible labor leaders and employers have become interested in more peaceful ways of settling their differences than by strikes and lockouts. Many disputes have been settled by arbitration, and there is some effort being made to compel arbitration. The present tendency is to use the methods of mediation and conciliation. The War Labor Board was appointed for this purpose during the war and had some success. The principle of a cooling-off period has been suggested for all industries as it is now applied to railway disputes. No doubt after a return to normal industrial activity, this suggestion will have a further hearing.

#### Questions to Test Your Knowledge

- 1. List several measures used by employers to counteract strikes.
- 2. How does a lockout differ from a boycott?
- 3. Define an injunction.
- 4. Why and how are injunctions used?
- 5. Explain what yellow-dog contracts are.
- 6. Are yellow-dog contracts legal in the United States?

- 7. Why do employers sometimes resort to espionage?
- 8. Distinguish between voluntary and compulsory arbitration.
- 9. What is a cooling-off period?
- 10. How might such a period reduce the number of strikes and help to settle a dispute peacefully?

#### Questions for Discussion and Application

- 1. Show how the use of a black list by employers might prevent a worker from ever obtaining work at his trade.
- 2. What is the difference between a yellow-dog contract and the demand of labor that a worker must join a union in order to work in a plant?

  Can you justify one any more than the other?
- 3. Organized labor is said to oppose the idea of a cooling-off period before a strike is called, because it will interfere with their right to strike. Can you think of any argument with which to oppose this attitude? Has organized labor a right to strike?
- 4. Canada has in effect a system of compulsory investigation of labor disputes which operates somewhat like the Railway Labor Dispute Act. Look up the Canadian practice and determine whether you believe it to be a better method than voluntary arbitration.
- 5. Why should labor be opposed to compulsory arbitration?

#### Floor Talks and Written Reports

- 1. Pros and cons of compulsory arbitration.
- 2. The National Labor Relations Act.
- 3. Implications of a cooling-off period.

#### Topic for Debate

RESOLVED, That a cooling-off period should be required before any strike or lockout is permitted.

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### Part VI Government and Finance

Chapter XXIX:

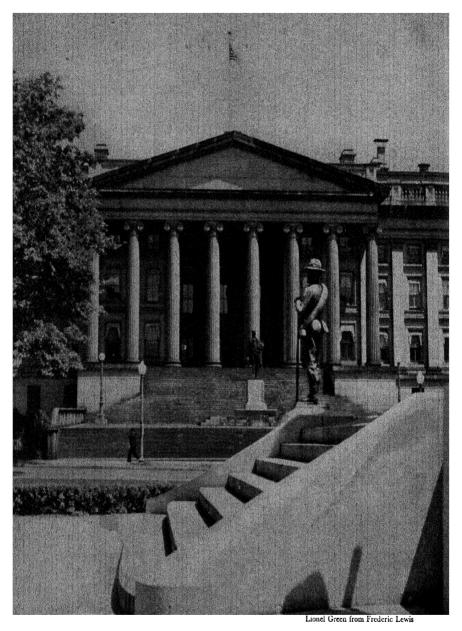
WHY GOVERNMENTS NEED MONEY

Chapter XXX:

HOW GOVERNMENTS OBTAIN THEIR FUNDS

Chapter XXXI:

GOVERNMENT AS A REGULATOR



The old treasury building in Washington, D.C. The statue on the steps of the building is that of Alexander Hamilton, first Secretary of the Treasury.

#### Chapter XXIX

### Why Governments Need Money

#### Aims of This Chapter:

To learn what is meant by government.

To realize that governments expend huge sums of money.

To find out where government funds go.

To discover why government expenditures have increased.

The preceding parts of this book have dealt with the four factors of production: natural resources, labor, capital, and management. You have learned the role that each of these factors plays in the process of producing goods: how goods are exchanged and what agencies are needed to make this exchange efficient. Finally, you have learned how the national income is divided among the factors named above.

Government as an Economic Factor.—Throughout the discussion you have heard of government and know that it is necessary if there is to be orderly production and exchange of goods. But you have not learned how important the factor of government is in our everyday economic life. Government has assumed an increasing significance in business life as well as in our personal lives. It is obtaining and expending huge sums of money which come out of the pockets of every citizen of the country. It is regulating and controlling the activities of industries, labor groups, and individuals to an extent never before attained. You want to know why governments require so much money, how this money is obtained, and what is done with it. You also want to know what caused governments to assume the function of regulator and why they have added so vastly to this function in recent years. This chapter will deal with the reasons governments need so much money.

What Are the Units of Government?—Before we discuss why governments need money, it will be well to make clear that we live



verue r nom

GASOLINE TAX—This is one of the important sources of revenue for state governments, as everyone who drives a car must pay the tax. The Federal government also gets a slice of the tax.

under three different units of government each of which calls upon us for a part of our incomes. These three forms are local, state, and national governments.

Local government may be the government of a village, a town, a county, or a city. Each of you is subject to the laws of at least one of these units. Local government is the unit that touches you most closely. You are a part of it and so are more conscious of its activities. Your local papers are full of items regarding the activities of your local government. Among these are the protection of life and property by policemen and firemen, the building of sewers and sidewalks, the operation of schools, the granting of licenses, the conduct of elections, the disposal of garbage and waste, the collection of taxes, and many more.

Next to the local government all of us are subject to a *state government*. This unit is farther removed

from us than our local government, but its activities are such that we are always conscious of its existence. No one may operate an automobile without first obtaining from the state a license to drive it and must register it with the state authorities. If a group of people wish to organize a corporation, they must obtain a charter from the state. State police patrol our state highways and investigate crimes. The state legislature passes many laws which affect almost every aspect of our lives. Most states tax our incomes and require us to pay gasoline taxes.

Above both the local and the state governments stands the *national* government. The national government seems a long way off and, until recent times, we were not so conscious of it as we are of the other units. For a few decades now we have been made more and more conscious of the fact that there is a government in Washington which is reaching

out constantly into states and local communities and directly affecting our lives. The Army and the Navy protect us from invasion and fight our enemies abroad; the Federal post office carries our letters and magazines; the national government pays pensions to old people, to veterans and their dependents; the national government regulates our working conditions and even our living conditions.

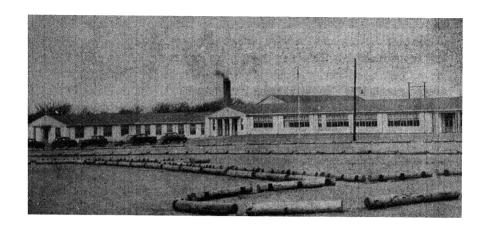
Thus you see that three units of government affect your daily lives and demand a share of your earnings for the performance of the services that we as a people demand. We shall consider the needs of each of these units, but the major emphasis will be placed upon the needs of the national government because it spends the larger part of the national income and performs services vital to our existence.

Governmental Expenditures.—Everyone today is aware that the national government is spending huge sums of money and that this has been going on for some time. We used to be surprised when Congress appropriated three billions in one session, but few people realize how the amounts spent by the three units of government have increased during the past thirty years. In 1913, before the First World War, the total expenditures of the three units of government were just a little under  $2\frac{1}{2}$  billion dollars; in 1925 this total jumped to about 10 billion dollars; in 1935 it was about 15 billion dollars; in 1940 it had passed the mark of 20 billion dollars. In 1944 the national government alone was expected to spend 100 billion dollars.

Where Does the Money Go?—These sums are enormous, and it does not seem possible that governments could find a use for so much money. What do they do with it? Where does it all go? It is spent for many different services and for all kinds of goods. For the past few years by far the largest part of these sums was spent for purposes of war and defense. What is left goes to pay for the usual and unusual operations of our government; for the operation of the various bureaus and agencies that regulate and control prices, wages, railroads, etc.; for expenses of relicf, pensions, social-security benefits, unemployment, and a host of others.

The largest items in local and state expenses are for highways and schools. Protection of life and property requires a large sum, while other large sums are needed for hospitals and public health purposes. Then, of course, there are salaries and the costs of administration.

Why Have Government Expenditures Increased So Greatly?— Why does it cost so much more to carry on our governments now than



Courtesy of Planeview High School, Wichita, Kansas

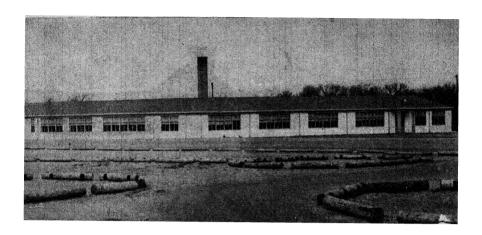
TAXES MADE THIS POSSIBLE—The township high school shown on this and the opposite page was built with funds raised by the local government. It has a twelve-month academic and recreational program and has a summer attendance about 25 per cent of the winter enrollment.

it did thirty years ago? It would require too much space and would prove tiresome to list all the reasons government costs have increased; so we shall group these causes and explain the more important without trying to arrange them in any order of importance.

Expansion of Government Services.—There has been an ever increasing demand for governments to perform services which formerly were performed by private agencies. In fact, it was once the belief that government should not enter certain fields but leave them to individuals or private agencies.

Education of a general nature has long been supported by public funds, but there has been an increasing demand that governments provide certain forms of education that were once provided without aid of government. Industries once trained their own mechanics and employed only those so trained. But now we find trade and technical schools in all industrial cities of any size supported by public funds; these are now training mechanics for industry. Many states now maintain agricultural colleges, schools of forestry, and mining schools. Little objection is made to these expenditures, but they account for much of the increasing cost of operating governments.

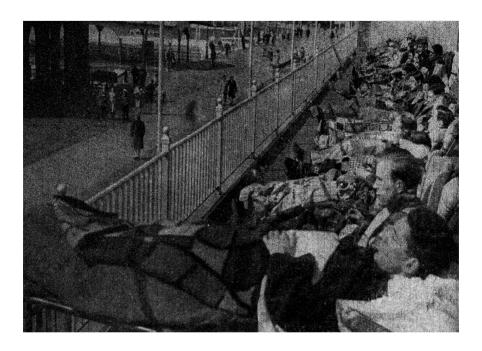
Recreation is another matter that once was provided by individuals at their own expense. But governments now provide much of our recreation facilities as part of their program of safety and crime prevention. Many cities maintain free municipal golf courses, tennis



courts, baseball diamonds, swimming pools, stadiums, playgrounds, and parks. These facilities are maintained at public expense for the benefit of the community.

Military Expenditures.—These account for the major part of the total expenditures of government, especially the national government. In the United States we have just experienced the expenditure of the largest sums of money in the history of any nation to win the most expensive war of all history. During the war these sums went for the manufacture of materials and equipment necessary to wage a total war and for the wages paid to workers in the thousands of war plants. But with the end of the war these expenditures do not cease. Vast sums are needed, not for making war materials and for paying wages, but to pay for the care of disabled soldiers and sailors, to provide for the dependents of those who lost their lives, to aid in reconverting industries to normal conditions, and to help veterans to find jobs. A large sum will be needed to pay interest on the huge debt that has been incurred and to aid the peoples of those nations which were ruined by the Axis powers. It will be necessary to maintain a large Army and Navy for occupying foreign countries until they can be restored to peacetime activities. As a result of the war we shall probably be spending money for many generations.

Extenditures Due to Economic Depression.—During the great depression which began in 1929, governments were called upon to spend huge sums for the relief of those who suffered because of the changed conditions. Farmers were aided to keep their farms; homeowners were assisted in maintaining their homes; the aged were provided for;



Courtesy of England General Hospital

ARMY CONVALESCENT HOSPITAL—A large item of government expense resulting from the war is the care of wounded and disabled servicemen. At the Army's beachfront England General and Convalescent Hospital in Atlantic City, sick and wounded soldiers from far-flung battlefronts watch the passing boardwalk parade from a sundeck.

even banks and businesses were assisted with large sums. These sums were spent in an effort to ward off disaster to millions of unfortunate beings who had lost money and jobs, and to restore confidence and stability to our economic life. You are all familiar with the WPA, the CCC, the NYA, the AAA, and other alphabetic agencies which were set up to carry out the purposes of the government. If you wish to learn more about them, consult your American history texts.

Social-welfare Activities.—Closely related to expenditures to promote economic recovery are the huge sums spent by governments for slum clearance, for better housing, for food purchase and distribution. In addition, millions have been spent for flood control, for soil conservation, for developing cheap power, and for building many miles of hard-surfaced highways. The list is long and more could be added; but enough has been said to show you why the costs of operating our units of government have been increasing steadily during the past few decades.



Courtesy of Farm Security Administration, Photo by Lange

HOUSING PROJECT—Model homes such as this were built in Arvin, California, by the Farm Security Administration to rent to low-income farm workers at a monthly rate of \$8.20, including water and electricity.

Summary.—Natural resources, labor, capital, and management have always been essential in the process of producing and exchanging goods. But, in recent years, government has assumed a position of greater significance than ever before. Indeed, many consider that government is now the most prominent factor in our economic life. It touches every individual and business enterprise; it holds in its hands the power to determine our every action. There was a time when government had little direct interest in the affairs of individuals and confined itself to the conduct of matters that concerned the country as a whole. But all that has been changed. Today, governments perform services of all kinds, many of which have been performed privately for years. Government regulates business, production, consumption, and many individual activities. Government has assumed these activities because the demand that it do so was made by all groups. However, these extra responsibilities have added to the cost of operating government and have brought about the serious problem of how to provide the funds to meet the burdens.

#### Questions to Test Your Knowledge

- 1. Name the units of government under which you live.
- 2. What are some of the services performed by your local government?
- 3. What are some of the things your state government does for you?
- 4. What has caused us to be more conscious of the national government than we formerly were?
- 5. Name some services performed by the national government.
- 6. What are the largest items in the expenses of state and local governments?
- 7. Which unit of government spends the largest amount for education?
- 8. List several reasons why government expenditures have increased so rapidly in the past thirty years.
- 9. Name some personal services now performed by governments that were once performed by individuals or private agents.
- 10. What are some of the economic changes that have caused governments to spend vast sums of money?

#### Questions for Discussion and Application

- 1. Explain what is meant by saying that government is now probably the most significant factor in our economic life. Give several examples to support your statements.
- 2. Why has the national government become the greatest spender of public funds?
- 3. In what ways has the national government recently spent money to aid banks, railroads, and businesses? Do you approve of this? Do you think it is a step toward socialism?
- 4. How do you justify the expenditure of public funds to maintain recreational facilities for the community?
- 5. Show how the recent depression has caused a complete change in the method of taking care of the needy. Do you believe that this change has been good for those receiving aid? for society in general? Discuss.
- 6. Should the care of the unemployed be a burden on governmental finances? Upon what theory can you justify the expenditure?

#### Floor Talks and Written Reports

- 1. Effect of government aid upon private charity.
- 2. Rugged individualism vs. collective responsibility.
- 3. The NYA and its affect upon youth.

#### Topic for Debate

RESOLVED, That government assumption of relief for the needy and the aged is detrimental to society.

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#### Chapter XXX

## How Governments Obtain Their Funds

#### Aims of This Chapter:

To learn the sources of government income.

To examine the theories of taxation.

To discuss the various kinds of taxes.

To suggest features of a good tax.

The preceding chapter pointed out the reasons for the great increase in government costs during the past thirty years. It will be the purpose of this chapter to examine the sources of government income and to discuss the various forms of taxes used to obtain a large part of the money needed.

How Do Governments Obtain Their Funds?—Now that you know that all units of government are in constant need of large sums of money to carry on their functions and to perform the many services demanded of them, you will want to know how governments obtain these funds. Governments have several ways of raising funds.

Through Customs Duties.—The United States government has always obtained a part of its revenues from the levying of tariffs, or "customs duties" as they are usually called. These are taxes levied upon articles brought into the country. Tourists returning from abroad are required to pay a duty or tax upon some of the articles they bring in with them. They are permitted to bring in a certain amount duty free but must pay a tax on all above this amount. Considerable revenue is obtained from the duties levied upon foreign goods brought into this country for resale here. That is one reason why foreign trade is considered important. The protective aspects of the tariff, however, are more important than its financial aspects. The relative importance of the tariffs as a source of revenue has declined in comparison with



Wide World Photo

CUSTOMS DUTIES—These RAF pilots are having their baggage checked by a British Customs official at a Transatlantic terminal base after ferrying bombers to England. They are permitted to bring in small gifts for their friends free of duty.

other more recent sources of governmental funds, such as the income tax.

Through Licenses, Fees, and Assessments.—In return for certain special services which confer a benefit upon the individual, the government exacts a fee. The registration of a deed, the issuance of a passport, or the registration of a patent requires such payment. A license is a charge in payment for a privilege. Examples of this arc marriage licenses and licenses required of owners of automobiles or for permission to conduct a certain business or to engage in certain occupations, such as the practice of law or medicine.

Assessments are levied on the owners of land for certain improvements that have increased the value of the land. Street and sidewalk improvements, building of sewers, and extension of water pipes are common forms of assessments.

Through Borrowing Money.—All units of government are obliged at times to borrow sums of money, especially when some large project is under consideration. Local governments borrow money to build

schoolhouses and highways, to develop waterworks and dams, and to make up deficits in annual revenues. State governments borrow for similar reasons and for other purposes. The national government borrows money to wage wars, to strengthen defenses, and for public improvements when it is not wise to raise the entire sum through taxation. Recently the national government borrowed vast sums for slum clearance, relief of farmers, homeowners, and the unemployed. Still more recently enormous sums have been borrowed through war bonds to finance the Second World War. When governments borrow money, they add greatly to the public debt. The present debt of the United States government is estimated to be about 300 billion dollars and is increasing steadily.

It should always be remembered that governmental borrowing is an emergency measure and neither a permanent nor a net revenue. Funds so raised must be repaid. Loans produce funds, but they are offset by dollar-for-dollar obligations plus the interest to be paid on them. If the loans run from twenty to thirty years, the interest mounts up to the principal, in which case for every dollar borrowed \$2 must be repaid. Hence, governmental borrowing is a source of loss instead of gain.

Through Taxes.—These are the principal sources of income for all units of government. They affect directly the economic welfare and standard of living of every citizen and so deserve a more detailed consideration than the other sources of revenue.

A tax has been defined as a compulsory charge imposed upon persons and businesses by the government for public purposes without reference to benefits conferred.

Theories of Taxation.—Taxes are usually levied in accordance with two theories which we shall explain briefly.

According to Benefits Received.—This theory maintains that those who receive benefits from government should pay for the services rendered. It is upon the benefit theory that assessments and fees are based, because it is not difficult to apply the theory in these cases. But in the case of taxation it is much more difficult to apply this theory. There is no accurate measure for determining how much benefit an individual receives from a governmental service; moreover, it is almost impossible to determine how much more benefit one person receives than another. Sometimes those who receive the greatest

benefit from government are the least able to pay taxes. The workingman with a large family of children receives more benefit from public education than the wealthy man with one child. Yet the workingman is not taxed so heavily as the wealthy man. In fact, he may not pay any direct tax at all. The poor person is benefited by public playgrounds, clinics, parks, and care of dependents, yet taxes are not apportioned according to benefits received. Hence, we must look for another theory of taxation.

According to Ability to Pay.—This is the most generally accepted theory of taxation today. The principle is that those who are in the best position to pay taxes because of their greater wealth should contribute in greater amounts to the expenses of government.

The application of this theory brings up the important question of what is a fair measure of ability. Should it be based upon the amount of property one owns, or upon the size of one's income, or upon what one spends? As a matter of practice all three of these measures are used. The ownership of property is considered evidence of the ability of the owner to pay taxes from some source. Wherever there is income, there is ability to pay something; but since many people have such low incomes, it has been the common income-tax practice to exempt all incomes below a designated amount. If people spend money for automobiles, fur coats, opera tickets, etc., it is assumed that they are able to pay taxes. This is one of the reasons for levying taxes on gasoline, and so-called luxuries.

How Are Rates of Taxation Determined?—With the general acceptance of the size of income as a measure of one's ability to pay taxes, there arises a question as to how the rates shall be determined. Does a man who has twice as large an income as another man have only twice the ability to pay as the man with half his income? Shall one be taxed at a higher rate than the other? Or shall they both be taxed at the same rate? In practice, taxes are sometimes proportional and sometimes progressive.

A proportional tax is one which is levied at the same rate upon all taxpayers regardless of the amount of income. Whatever the rate may be, it is applied to all alike. For example, if the rate is 4 per cent, a man with an income of \$2,000 will pay \$80; while a man with an income of \$5,000 will pay \$200. One pays a higher tax than the other but the rate is the same.

A progressive tax places an increasing rate on income as the income

increases. Thus a man with an income of \$2,000 would pay 4 per cent, or \$80; a man with an income of \$10,000 would pay 6 per cent, or \$600; while a man with an income of \$100,000 would pay 30 per cent, or \$30,000.

Classification of Taxes.—Taxes are usually classified as either direct or indirect.

Direct taxes are those which are levied directly upon the person or business concerned, who know they are paying it. The income tax is the best example of a direct tax because it is levied upon the person or business which earns the income and is paid directly by him or it.

Indirect taxes are those which are paid by individuals upon whom they were not originally levied. For example, the manufacturer of automobiles is charged a certain tax upon each car that he produces. He pays this tax to the government and then adds the amount of the tax to the price of the automobile. The purchaser of the automobile thus pays the tax indirectly. When you buy playing cards, cigarettes, or cosmetics, you pay a tax in addition to the original price of the article. The manufacturer has affixed to the article stamps which he has purchased from the government. These are proof that he has paid the government tax. But he gets his money back from you when you buy.

This passing of a tax on to another is called *shifting* the tax. Some taxes are regularly shifted; when they are levied, it is expected that they will be passed on to the consumer to pay. Other taxes cannot be shifted, such as income and inheritance taxes.

Although every tax is either a direct or an indirect levy upon your wealth, they assume different forms usually named according to the particular thing upon which the tax is levied. We shall describe several of the more common forms of taxes.

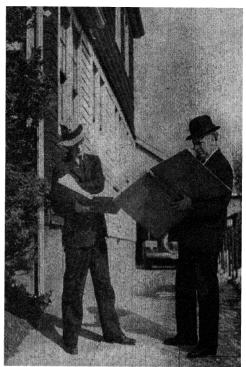
What Are Property Taxes?—This is one of the oldest forms of taxes and is the most productive of all taxes. It is used chiefly by local governments, although the states make some use of it. The Federal government levies no property tax. It is levied upon both real estate and personal property, with some exceptions. No tax is levied upon the property of religious, educational, and charitable organizations since they render services for the common welfare. Likewise, property owned by any unit of government is exempted from this tax.

Real property or real estate consists of land and all fixtures attached to it, such as buildings and all improvements. Real property is taxed

by the district in which it is located. It is the main source of revenue for towns and cities.

Personal property consists of all possessions other than real estate. Thus household goods, money, stocks, bonds, livestock, automobiles, jewelry, and notes are examples of personal property. Personal property is taxed at the place of residence of the owner.

Although the property tax brings in much revenue, it is probably the most unpopular form of taxation we have. Property taxes are usually levied upon a certain valuation of the property. These valuations are determined by elective officials known as "assessors." It is claimed that the valuations placed upon property are not fair and that there is too much difficulty in arriving at a fair

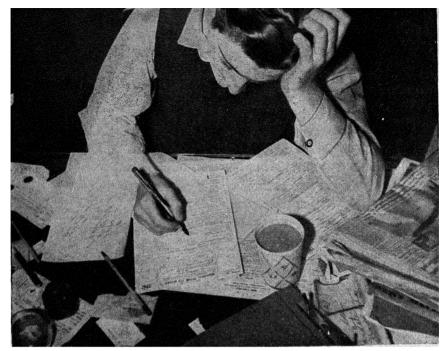


Ewing Galloway

PROPERTY TAXES—Tax assessors appraise a house to determine what tax the owner shall have to pay. Property taxes are the main source of income for local governments.

valuation. The same valuation is often continued year after year, even though the actual value of the property has changed. Assessed values differ in different communities and at different times. Some communities tax real estate at one-half its value, and some at two-thirds its value. If your home is valued at \$4,000 and the custom in your community is to tax upon half the value, your father will pay a tax on \$2,000. The rate of taxation is usually expressed in dollars per thousand, as \$32 per thousand. At this rate your father would pay a real-estate tax of \$64.

Much personal property can be concealed and thus escapes taxation. This is an unsatisfactory feature of this kind of tax as it enables those who own stocks and bonds to escape it entirely. Real estate can be seen and is not easily moved; it can be taxed quite easily. Personal



Acme Photo

WHY THERE ARE HEADACHES—This photo represents a scene which is quite familiar to millions of us about March 15 of each year. Filling out income tax returns calls for black coffee and aspirin as well as the burning of "midnight oil."

property is usually within the home or in a safe-deposit box where the assessors do not see it, and thus it escapes taxation.

Income Tax.—This is a tax levied upon the income of an individual or a business. Since 1913 Congress has had the power to levy a tax on incomes. Many states also levy income taxes. Several advantages are claimed for the income tax. It is based on ability to pay, is a progressive tax, cannot be shifted, and is easy to collect.

Since 1913 Congress has enacted a number of laws applying to incomes. These laws have changed the rates and the manner of administration, as well as the number of people required to pay the tax; but the general principles of the laws have not been changed.

The general principles under which income taxes were levied can be stated briefly. Certain exemptions were allowed for single persons, for married couples, and for dependents. Deductions were also allowed for taxes paid, contributions made to charitable organizations, business expenses, interest on debts, and medical bills up to a named percentage of income. The tax was levied on net income, which is what is left after subtracting the personal exemptions. Then in 1942 a new feature was added in the form of a *Victory tax*. This was a certain percentage charged on total income above a prescribed amount. The rates are progressive.

These regulations and changes caused a great deal of grumbling and uncertainty when the time came to file returns. A demand for a simplified income tax was made. Finally, in 1944, Congress passed what is called a "simplified" income tax law. We cannot give all the details of this new law, but the general features can be given.

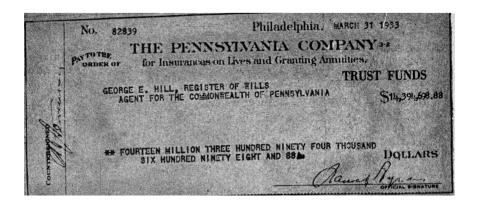
The Victory tax has been repealed. Uniform exemptions of \$500 are provided for everybody. Thus a married man will have \$500 exemption for himself, \$500 for his wife, and \$500 for every additional dependent. The normal tax rate is reduced from 6 per cent to 3 per cent. The surtax rate begins at 20 per cent instead of 13 per cent. Exemptions apply against both surtax and normal tax.

The present plan of paying income taxes is called the "pay-as-you go" system. Under this plan most individuals pay all or a large part of their income tax during the year in which they receive their income. The tax is withheld from their wages or paid in quarterly installments as estimated tax, or both. However, since these payments do not always equal the actual tax liability, it is necessary to file so that any additional amount due may be collected or any overpayment be refunded.

The income tax includes a *normal* tax and a *surtax*. Both are figured as percentages of income but with different rates. The *normal* tax is a flat rate of 3 per cent. The *surtax* is at graduated rates ranging from 20 to 91 per cent.

For the normal tax, an exemption of \$500 is allowed the taxpayer and \$500 additional for each dependent. In case a husband and wife file a joint return, the combined normal tax exemption is \$1,000 if each has income of \$500 or more; but if the income of either is less than \$500, the combined normal tax exemption is \$500 plus the actual amount of the smaller income. Thus, if a man has an income of \$1,900 and his wife has an income of \$300, he is allowed to deduct \$500 for himself and \$300 for his wife, or \$800 in all.

For the *surtax*, an exemption of \$500 is allowed for the taxpayer, \$500 for his wife, and \$500 for each dependent relative, if he has any. The relatives must be closely related and must have received more than half of their support from the taxpayer during the year.



Acme Photo

INHERITANCE TAX—This check represents the inheritance tax from the estate of the former head of the Campbell Soup Company. Note the amount of the check.

If the dependent had \$500 or more income of his own during the year, the exemption does not apply. This means that if a child earns over \$500 during the year, the father cannot deduct \$500 from his income on the child's account. The child must file his own return.

Death Duties and Gift Taxes.—There are three forms of death duties, two of which are levied on the transfer of property after death and the third on gifts made by a living person in anticipation of his death. The first two are commonly described as the *estate* tax and the *inheritance* tax.

The estate tax is levied on the value of the estate as a whole before it is passed on by inheritance. It is used by the Federal government. Although the transfer of inherited property is determined by state laws, the Federal government collects most of the death taxes. After the estate is broken up into smaller shares, each state in which an heir lives collects a further tax from each heir. This is called an inheritance lax.

The purpose of the *gift tax* is to prevent the evasion of death duties. The gift tax amounts to about three-fourths of the estate tax.

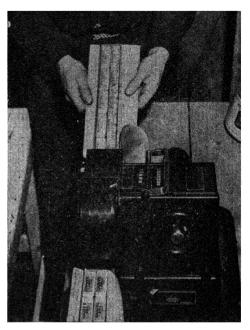
Poll Tax.—This is a tax levied on male citizens who have passed their twenty-first birthday. It is the oldest tax in history and the simplest of all. But it is no longer used extensively.

Nuisance Taxes.—These taxes are commonly called "excise" taxes. They are called "nuisance" taxes because they are placed upon many things of a more or less luxury nature that people use daily

and are usually small in amount. Examples of such taxes are those placed on tobacco, cosmetics, playing cards, cigarettes, and theater tickets. These taxes are easy to collect and bring in much revenue although they are not popular.

The Tax That "Soaks" the Poor.—The sales tax is relatively new in our country, but it is now used by many states and cities and has been proposed as a Federal tax. The state and local tax is placed on sales made by retail stores; rates vary from 1 to 3 per cent of the sale. Some states exempt certain essentials of life, such as food.

The sales tax brings in much revenue and is easy to administer.



Acme Photo

A NUISANCE TAX—This is the machine which is used by cigarette wholesalers in New York City for the collection of the one-cent-a-package tax on cigarettes.

But it is not popular with those who have to pay it. It is sometimes called a "soak-the-poor" tax because it places a heavier burden on those who earn small incomes. The smaller the income, the greater in general is the proportion of it spent for consumption needs and, hence, subject to the sales tax. If, for example, the rate were 2 per cent, the ratio of the tax burden to an income of \$1,000 a year would be much greater than it would be if the income were \$10,000. The real burden of the tax tends to fall on those least able to bear it.

Use Tax.—The Revenue Act of 1941 added a new Federal tax which became effective in February, 1942. It was called a "use" tax. The Federal tax was one of \$5 levied annually on the owners of all automobiles for their use. This tax was repealed, and no such tax has been payable since July 1, 1946.

Businesses Are Taxed Heavily.—Taxes are levied on all types of businesses. Such taxes are levied by the Federal government as well as by the states. For many years the only taxes levied on businesses were the property tax and special license taxes. But as corporations grew larger and larger and as their profits increased, there arose



"I Wonder, Doctor, If He Could Be Concealing Anything from Us?"

-Donahev in the Cleveland Plain Dealer

a demand that corporations should be made to pay heavier taxes. Today several very important taxes are levied on business units.

Corporation Income Tax. This is a tax levied on the net income of a corporation. Several states and the Federal government have such a law. The tax is severely criticized. It is said to be unfair because the corporation is taxed on its net income, and then the dividends that stockholders receive are also taxed. This is taxing the same income twice. Those who favor such a tax claim that it makes it

easier for small corporations to compete with large corporations. Others favor the tax because the government can use it to regulate the business practices of corporations.

Excess-profits Tax.—This tax was imposed during the First World War and was intended to stop profiteering. Profits beyond a certain percentage were considered excessive or too high, and so the law imposed a tax whose rates increased with the percentage of profits received. These rates varied from 20 to 80 per cent. In actual practice the tax was found to be complex and difficult to assess fairly because the corporations claimed that it was not possible to tell what percentage of profits was fair to each kind of business.

The excess-profits tax is a war emergency measure. It was repealed after the First World War but reapplied during the Second World War when a graduated scale from 35 to 60 per cent of excess profits was put into effect. The tax law of 1942 changed this to a flat rate of 90 per cent of excess profits with an exemption of \$5,000.1

In addition to the above-mentioned taxes on business, there are <sup>1</sup> Repealed in 1945.

other taxes levied, such as franchise taxes, charter fees, and many minor taxes.

What Should a Good Tax Be?—No one likes to pay taxes but most of us are reconciled to the fact that we must pay them if we are to have the things we enjoy at present. No tax has ever been popular and now with the new taxes and the increase in the income tax, a demand has been made for the simplification of taxes. In 1944 Congress complied with a new law which simplified the payment of income taxes but did not reduce the amount of tax. Many think that there are too many taxes and that they bear too heavily on some groups. What is a fair tax?

It is suggested that a fair tax should be based on the ability of the taxpayers to pay; it should be clear to the taxpayer why he is paying the tax; the payments should be arranged for the convenience of the taxpayer; it should bring in the needed revenue and should be adaptable to changes in economic and social conditions; finally, it should be easy to administer and not cost too much to collect. Other suggestions could be made and perhaps you may be able to add a few.

Summary.—The two chief sources of income for governments are through borrowing and through levying taxes. Borrowing does not furnish permanent revenue but taxes do. Taxes are of many kinds and have been levied on two principles: according to benefits received and according to ability to pay. The latter principle is more popular with those who make tax laws and seems fairer to all.

All taxes are either direct or indirect. Direct taxes, as a rule, are more difficult to shift to others. Indirect taxes, on the other hand, are frequently shifted to others. This is one reason why they are unpopular.

Among the many forms of taxation used to raise revenue, the property tax is most used by states and local governments. The income tax used by the states and the Federal government is a large revenue producer. It has been made more so by the enactment of recent laws. Nearly everyone who has a job now is required to pay an income tax. Then there are excise taxes, which are sometimes called nuisance taxes. These produce much revenue and are easy to collect although not popular. Sales taxes are levied by some states and cities. They are objected to because they bear hardest on those with low incomes.

All types of businesses are subject to some form of taxation. The

chief business taxes are the corporation income tax and the excessprofits tax. Many other minor taxes are levied on businesses, some for revenue and some for purposes of regulation.

No one has yet devised a perfect tax which all will like. Perhaps no popular tax can be devised. But suggestions have been made as to what a good tax should be. Some of our taxes meet these suggestions in part, but none of them meet the requirements in all respects. The tax problem will be with us for many years to come; in time we may approach a juster and simpler system of taxation.

#### Questions to Test Your Knowledge

- 1. List the four common ways by which governments raise funds.
- 2. What happens when a government resorts to borrowing funds?
- 3. How do you define a tax?
- 4. State the principle of the benefit theory.
- 5. Explain and illustrate the ability-to-pay theory of taxation.
- 6. What is a proportional tax? a progressive tax?
- 7. Distinguish between a direct tax and an indirect tax.
- 8. Why is the tax on real estate so unpopular?
- 9. Explain the so-called death taxes.
- 10. Why are sales taxes unpopular with those on low incomes?
- 11. State briefly the terms of the latest income tax law.
- 12. What are some of the suggestions made for a good tax?

#### Questions for Discussion and Application

- 1. Taxation according to ability to pay has been called a penalty on one's ambition. Do you agree or disagree? Discuss.
- 2. Show that a man on a very low income whose direct tax bill is nothing really pays many local and national taxes.
- 3. "From each according to his ability, to each according to his need."

  This is the Socialist ideal. Is this the theory underlying progressive taxation? Do the recent increase in social legislation and the changes in the income tax law indicate that government is unconsciously serving this purpose?
- 4. Discuss the possibility of shifting the following taxes: (a) the real estate tax, (b) the income tax, (c) a sales tax, (d) a customs duty.

5. Discuss the effect of heavy taxes on corporations on (a) the corporations themselves, (b) the stockholders, (c) those who buy their goods.

#### Floor Talks and Written Reports

- 1. An ideal tax system.
- 2. The general sales tax.
- 3. Shifting taxes.

#### Topic for Debate

RESOLVED, That a general sales tax is both just and desirable.

#### For Further Information

Building America, "Taxes," Vcl. IV, No. 5.

Coyle, D. C., "Why Pay Taxes?"

Greenwood, E., "Spenders All."

Kendrick, M. S., and C. H. Seaver, "Taxes: Benefit and Burden."

National Association of Manufacturers, "Taxes and You."

National Education Association, "How Our Government Raises and Spends Money."

Public Affairs Pamphlets, "Our Taxes and What They Buy," No. 28.

Taylor, H., and Associates, "Main Currents in Modern Economic Life," Chaps. 41–44.

#### PROBLEM 33

#### The General Sales Tax

From time to time the general sales tax has assumed prominence in discussion of methods of raising larger sums of money to meet the ever increasing expenses of government. Many states have had such a tax for several years and several cities have them. The Federal government has not yet enacted such a tax although there has been a serious demand that it do so. Many serious objections have been raised to such a tax, and many arguments have been made in its favor. There is a possibility that in our desire to pay off the huge debt that we owe, Congress will be forced to enact a Federal sales tax law, since many believe that it will not be wise to increase income taxes further.

- 1. What is a general sales tax?
- 2. Should there be any articles exempted from such a tax?
- 3. What effect would such a tax be likely to have on consumer buying?
- 4. Would such a tax lead to inflation of prices and wages?

- 5. Would such a tax cause hardship to any group? if so, what group?
- 6. Would such a tax conform to any of the suggestions for a good tax?

#### PROBLEM 34

#### Consumers and Taxes

One of the big problems facing every consumer today is how to maintain a budget in the face of the numerous taxes that must be paid. The Brownells are no exception. Mr. Brownell finds that the income tax takes a large part of his income even after deductions and other allowances. Then there is the real-estate tax which takes another sizable portion of the income. But this can be allowed for in the budget. It is the many small and often unseen taxes that cause the trouble. These are placed upon almost everything the family uses, such as toilet articles, cosmetics, drugs, gasoline, and theater tickets. It is difficult to estimate these in advance. However, they must be paid if the government is to pay its debts and furnish the services demanded by the people.

- 1. Give as complete a list as you can of the taxes paid by the Brownells.
- 2. Is it possible to estimate the income tax for budget purposes?
- 3. What deductions would Mr. Brownell be allowed before paying his income tax?
- 4. If the income tax is approximately 20 per cent, how much would Mr. Brownell actually pay as a tax on an income of \$3,400?
- 5. List some of the benefits enjoyed because of taxes paid.

## Chapter XXXI

# Government as a Regulator

#### Aims of This Chapter:

To learn the purpose of government regulation.

To find out why big business was regulated.

To examine the antitrust laws.

To discuss governmental regulation of economic activities.

To review wartime regulation.

You have learned of the activities and services government engages in for our welfare and how it obtains the funds to carry on its ever-increasing functions. In addition to these services, government has gradually assumed control over many economic activities. It has not always assumed this control of its own accord; it has done so as a result of demands made by consumers, businessmen, bankers, farmers, and labor groups. More recently the government has taken on a function that is becoming more significant each year. This is the function of regulation; it will be the subject of this chapter.

Purpose of Regulation.—When the government regulates the services supplied by industry and the prices they charge for their goods, it necessarily interferes with private enterprise. When it not only regulates the prices paid for goods but tells us what goods may be had and what may not be had, it interferes with personal freedom to a certain extent. What right has it to do these things? The Federal government regulates chiefly under the "interstate powers" given it by the Constitution. The state governments regulate under what is known as its "police power." Governments may regulate any business that is "affected with a public interest." The legislatures determine what businesses are affected with a public interest, and the courts have usually given approval. We may say then that governments regulate businesses and economic activities in the interests of the general public.

Government has not always exercised the function of regulation; for many years the policy was one of keeping hands off business activities. This was known as the policy of *laissez faire*. So long as business conducted itself with regard to the public interest and welfare, government did not interfere. But, as we have seen, big business and the railroads often resorted to practices that brought demands from the public that something be done to remedy conditions. Then the government took action.

Why Does the Government Regulate Trusts?—In our discussion of the organization of big business in Chapter XXIII, you learned that many combinations grew so large that they became virtual monopolies. These combinations became so powerful that they sometimes ignored entirely the interests of the public in their desire to control supply, to set prices, and to make big profits. Although these large combinations have brought many benefits to consumers, they resorted to practices that were harmful to the public and complaints against them became numerous and persistent. Chief among these complaints were the following:

Trusts Have Been the Cause of High Prices.—Soon after combinations became general, a gradual rise in prices took place. Whatever may have been the reason for this rise in prices, the public resented it and blamed the trusts for it.

Trusts Have Used Unfair Business Tactics.—This complaint has been made chiefly by independent competitors who claim that the big combinations are able to cut prices to a point which independents cannot meet and which forces the "little fellow" out of business. Once competition is checked, prices rise again, sometimes even higher than before. Another complaint is that combinations take advantage of their size and power to force from shippers rebates and other concessions that small dealers cannot obtain.

Trusts Cause Concentration of Wealth in the Hands of a Few.—Most of the large combinations are controlled by a relatively few people, who have thus been able to gain great wealth. This has tended to concentrate great power and influence in the hands of a few. The situation thus brought about has been criticized because it tends to develop an industrial aristocracy, which is out of place in a democracy.

Trusts Have Too Much Influence on Legislation.—Because of their huge resources the large combinations are able to maintain highly

paid representatives, called "lobbyists," at state capitols and in Washington, D.C. These lobbyists work actively for or against certain bills which the combinations favor or oppose. In the past, big business has made large contributions to political parties. These have made it possible for them to elect officials who favor their policies.

Regulation of Big Business.—Because of these and other undesirable practices, it was deemed necessary to curb the activities of combinations that tended to stifle competition. At first the states took action and passed laws restraining such combinations within their borders. Most of these laws were weak; many were not enforced vigorously. Most of the combinations that the states were trying to curb were engaged in interstate business and so were not affected by state laws outside the boundaries of the state. If regulation was to be effective, the Federal government would have to undertake it. So, beginning in 1890, several Federal laws were passed to regulate the activities of large corporations. We shall explain briefly the most significant of these laws.

Sherman Antitrust Act, 1890.—This act declared illegal any combination that restrained trade; that is, that attempted to lessen competition. Penalties were imposed for violations of the law. Several suits were brought against corporations, but it proved almost impossible to get enough evidence to convict them. The law contained too many loopholes through which the trusts escaped without much harm. The United States Supreme Court declared that the government must prove that any combination was unreasonably restraining trade. This is the so-called "rule of reason." Mere size was declared not to be an offense.

Clayton Antitrust Act, 1914.—This act was intended to strengthen the Sherman Act. It defined more clearly the specific practices that were considered as restricting competition. It forbade unfair competition, forbade price discriminations between purchasers when they tended to lessen competition, and prohibited interlocking directorates under certain conditions. Interlocking directorates are those in which the members of the board of directors of one holding company are also directors of another holding company.

Federal Trade Commission Act, 1914.—This act created a commission which was expected to eliminate business practices that restrained



Wide World Photo

NATIONAL INDUSTRIAL RECOVERY ACT—In March, 1933, the National Industrial Recovery Act was passed to set up codes of fair competition. Later, however, the United States Supreme Court declared the law unconstitutional. Thus we see an evidence of checks and balances, one of the main characteristics of our Constitution.

trade. The Federal Trade Commission has power to investigate the affairs of all corporations engaged in interstate or foreign commerce, except common carriers and banks, each of which is subject to its own governmental board of regulation; to issue orders restraining the use of unfair methods of competition; to make recommendations to Congress regarding changes in the antitrust laws. The Commission was given additional powers of regulating advertising by the Wheeler-Lea Act in 1938. The Commission is now able to protect consumers by taking action against misleading advertising of foods and drugs. Even though no competitor is injured in the advertising, consumers may be harmed or misled.

National Industrial Recovery Act, 1933.—This act was an emergency and recovery measure following the great depression. It provided for the establishment of codes of fair competition. A code was an agreement or set of rules drawn up by a group that represented the employers in the industry, the workers, and the government. When these codes were approved by the President, they were binding on the entire industry, whether all agreed to them or not. Each code was administered by a code authority selected by the industry. The whole system of codes was supervised and administered by the National Recovery Administration (NRA) headed by a national administrator. However, the act was declared unconstitutional by the United States Supreme Court because Congress had violated the Constitution when it delegated its power to make laws to another agency. During the time the act was in force, the antitrust laws were suspended.

Regulation of Public Utilities.—As you have learned, public utilities are legal monopolies because of the nature of the services they render. It is considered that competition in the field of public utilities would be wasteful and expensive. But in granting the monopoly rights, government has kept the right to regulate rates and the sale of securities. It is in the field of public utilities that holding companies have become so prominent. In some cases so many holding companies were formed that it became almost impossible to tell who owned them. State authority proved unable to cope with the vast web of holding companies that grew up during the 1920's. It is said that by 1929, holding companies controlled 82 per cent of the total energy generated by privately owned utilities. Combinations among holding companies has concentrated control until by 1929 three groups alone controlled 45 per cent of all electricity generated. So

many evils grew out of this concentration that the Federal government was compelled to take action.

Public Utility Holding Company Act, 1935.—This act sought to bring under governmental control the vast network of these supercorporations owning the stock of operating companies throughout the country. By the terms of the act all public-utility holding companies engaged in interstate business are required to register with the Securities and Exchange Commission, which has the power to investigate them in order to determine whether there is any good reason for their existence. If it decides that a particular holding company is not necessary to the operation of a single unified system, it may order that holding company to dissolve or give up certain of its subsidiaries. This provision is known as the "death clause" because it was expected that it would put an end to many of the large complex holding companies, particularly those owning stock in other holding companies.

What Did the Monopoly Inquiry (1938–1939) Recommend?—As a result of recommendations made by President Franklin Roosevelt, Congress passed the Monopoly Inquiry Act. This created a Temporary National Economic Committee (TNEC), which was given power to make a detailed investigation into every phase of the monopoly problem. In its first report in 1939, it recommended that holders of patents be prohibited from restricting the use of the patents by those licensed to use them; that the Clayton Act be amended to prohibit corporations from acquiring the assets as well as the stock of competitors; and that the government be authorized to institute civil suits for damages against all who violate the antitrust laws. The committee also investigated telephone companies, broadcasting companies, and the producers of popular music, to promote competition and to restrain monopoly.

Regulation of Transportation.—For a good many years the government was a generous benefactor rather than a regulator of railroads. You have learned that lavish grants of land and funds by all governmental units greatly aided the growth of railroad building. With this growth there came a number of abuses, which were described in Chapter XXIV. There you learned that the states were unable to stop these abuses and that the Federal government had to take over the job. Several of the acts regulating railroads were described in Chapter XXIV and need not be repeated here.

Mctor Carrier Act, 1935.—The rapid growth of motor transportation brought loss of business and financial worries to the railroads. They complained that railroads were subjected to strict regulations of rates by the Interstate Commerce Commission while the motor carriers were free from such restrictions. This they held to be unfair. In 1935 Congress heeded the demands of the railroads and passed the Motor Carriers Act, which placed control of motor carriers under the Interstate Commerce Commission. The act requires trucks and busses to conform to certain specified standards covering safety, insurance, rates of fare, and competitive practices with other lines.

Civil Aeronautics Authority Act, 1938.—So important had aviation become that the Federal government passed an act to regulate and control it. This law provides for a Civil Aeronautics Authority to supervise, regulate, and encourage civil aeronautics and to report on plans for the creation of a national system of airports. The Second World War temporarily suspended the work of the Commission. It is now at work on plans to improve and extend air transportation of passengers and freight as soon as conditions warrant.

Regulation of Labor Standards.—Government has also extended its control over the relations between employers and their employees. This has been done through laws regarding wages, hours, and conditions of work. You are already familiar with these through the National Labor Relations Act, The Norris Act, the War Labor Board, and others. These were discussed in Chapter XXVII. Other acts regulating labor relations and providing security for workers will be described in Chapter XXXIII. These laws are in a sense restrictions on individual freedom since they state what kind of employment contracts may or may not be made; what kind of employees a businessman may or may not have; how, when, and where women may work; what wages may be paid; and finally, through the Social Security Act, how unemployment and old age shall be provided for.

Government Exercises Control over Money, Credit, and Banking.—The government has interfered in economic affairs through its control over money and the banking system. Several of these controls were described in the chapters on money, credit, and banks (Chapters XII, XIV, XVI). After the collapse of the banks in 1933, people began to look to the government for a greater amount of assistance in the economic field than ever before. The result was that

government began to look upon the promotion of good times as its primary job. All sorts of laws were passed to bring about recovery. Among the chief controls adopted by government during this period were (1) control of bank credit, (2) currency devaluation and control of gold and silver markets, (3) control of security exchanges, and (4) control of personal credit.

War Conditions Require Many Regulations.—With the outbreak of the Second World War, which soon became a total war in which we became involved, the necessity for greater control by government over our economic activities became evident. Never before in our history have we been subjected to so many regulations which affected our lives so completely. You have lived through the war and are familiar with many of these regulations and restrictions. Only a brief review will be given here.

Control of Prices.—In order to hold prices down and prevent inflation, the government, in 1940, established an agency whose duty it was to work toward the stabilization of prices. In 1941 this agency was called the Office of Price Administration (OPA). It acted under the Price Control Act and had broad powers in the price field. Price ceilings were established on over 30,000 items of common purchase and merchants were forbidden to charge more than the price set. In 1942 rents were fixed in war-production areas that included all large cities. Farm prices were kept from rising too high by means of subsidies and other arrangements with farmers. Wages were set at a figure equal to what the worker earned on January 1, 1941, and thousands of workers were frozen in their jobs; that is, they could not change to better jobs. Raises were granted by the War Labor Board only to those who could prove that their purchasing power was not sufficient for a decent living standard.

Rationing.—In addition to setting prices on thousands of articles, it was found necessary to prevent those who had money to spend from rushing into the market and buying up the dwindling supply of consumer goods. This would deprive many of goods they needed for living. So rationing was adopted, in order to conserve scarce goods and to make them available to all on an equitable basis. You are familiar with the ration books and the coupons needed to purchase sugar, shoes, meat, butter, cheese, canned food, fuel oil, and gasoline.

Restrictions were placed upon the use of automobiles to conserve rubber and gasoline; we were even urged to refrain from traveling on trains in order that the space might be used for troops and supplies. Clothing was not rationed, but many articles of common use were not made at all or were made in smaller quantities. Hardly a phase of our daily living was not affected in some way by the regulations imposed during the war.

Summary.—Government regulation is not an entirely new thing in the United States. In spite of our boasted freedom of choice, we have always had some regulation of our economic activities. The Constitution provides for the regulation of interstate commerce. Trade has always been subject to some regulations, and tariffs have been in effect since 1792. From its beginning government has gradually assumed charge of many different economic activities. After the corporations assumed prominence and grew to huge combinations, it became necessary for the government to exercise control over their activities. Corporations were regulated by many acts in the interest of the public; railroads were compelled to submit to regulation, as were public utilities and banks. Monopolistic practices were curbed by antitrust laws, and consumers were protected by laws forbidding false and misleading advertising and adulteration of foods. Restrictions were placed upon employers in their dealings with their employees.

During the Second World War these restrictions and controls were further extended until they affected practically every activity of our economic and social life. Many think that these restrictions will have to be maintained for several years to come if everyone is to get a fair share of the goods produced and inflation is not to become rampant.

#### Questions to Test Your Knowledge

- 1. What is the purpose of government regulation?
- 2. Why did the government find it necessary to regulate big business?
- 3. List some of the abuses of corporations that led to regulation.
- 4. State the terms of the Sherman Antitrust Act.
- 5. What did the Clayton Act add to the Sherman Act?
- 6. What are the functions of the Federal Trade Commission?
- 7. What did the National Industrial Recovery Act attempt to do?
- 8. Why and how were the railroads regulated?
- 9. What regulatory measures were taken during the great depression?

10. List some of the more important regulations imposed during the Second World War.

### Questions for Discussion and Application

- 1. Discuss the weaknesses of the antitrust laws.
- 2. Why do large industrial combinations desire the repeal of the antitrust laws?
- 3. There has been some legislation regulating chain stores. Why do owners of small independent retail stores object to the competition of the chain stores?
- 4. Why is there so much interest in government circles regarding monopolies? Explain what the TNEC has accomplished. List its recommendations.
- 5. Businessmen have been restricted in the conduct of their businesses. Do you know of any legislation that restricts unions? Should there be such legislation? If so, what regulations would you suggest?
- 6. Discuss the regulation and control of prices during the recent war. Would you approve of the continuance of rationing in principle? What particular goods, if any, would you have rationed?

#### Floor Talks and Written Reports

- 1. The work of the OPA.
- 2. Pros and cons of rationing.
- 3. Government regulation or ownership.

### Topic for Debate

RESOLVED, That government regulation and control of the prices of essential goods should be made permanent.

#### For Further Information

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Public Affairs Pamphlets, "How Can We Pay for the War?" No. 74; "The American Way," No. 90.

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Temporary Economic Committee Monograph No. 31, 1941; No. 21, 1940.

#### Part VII

# Economic Stability and Progress

Chapter XXXII:

BUSINESS HAS ITS UPS AND DOWNS

Chapter XXXIII:

THE QUEST FOR SECURITY

Chapter XXXIV:

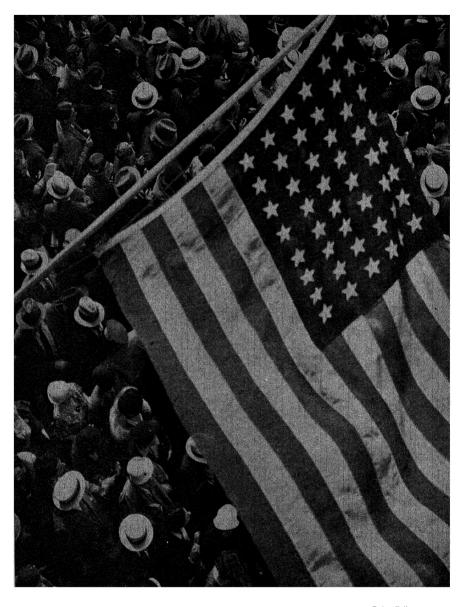
COOPERATION AND THRIFT

Chapter XXXV:

COMPETING ECONOMIC SYSTEMS

Chapter XXXVI:

WAR ECONOMICS AND RECONVERSION



Ewing Galloway

SYMBOL OF STABILITY—Under the Stars and Stripes millions of Americans are assured of stability and freedom in government and business.

## Chapter XXXII

# Business Has Its Ups and Downs

#### Aims of This Chapter:

To learn the nature of business cycles.

To give a brief history of business cycles.

To describe the periods of a business cycle.

To examine suggestions for remedying the evils of cycles.

Every businessman knows from experience that there are times when his business is good and when profits are to be made, but that there are other times when business is poor and when losses occur. He notes that the changes in business seem to have a sort of rhythm from good to poor and then to bad and back again to fair and good. These ups and downs have occurred so persistently that they have come to be known as "business cycles."

What Is a Business Cycle?—A business cycle has been defined as the changes that occur in husiness over a period of years marked by alternating periods of prosperity and depression. These changes, however, do not occur with any degree of regularity. They vary in severity and length. No two cycles are of the same severity, nor are they of equal length. Moreover, no two cycles seem to be characterized by the same economic conditions. Each cycle seems to be distinct in itself. In spite of the fact that no two cycles are exactly alike, they do have certain features in common; they are affected by similar fundamental forces. Moreover, some cycles have been world-wide; they have affected many nations and upset world trade. Other cycles have been confined to one country.

History of Business Cycles.—Throughout history there has been this periodic change in business from prosperity to depression and back again to prosperity. But our interest is mainly in the changes that have taken place in our own country. Our first crisis of any importance occurred in 1817. It was brought about by the trade adjust-



Underwood-Stratton

PANIC OF 1929—During the break of the stock market in the record panic of 1929, tension mounted as nearly 13,000,000 shares were traded. Here crowds are gathered at the New York City Subtreasury building, watching the excitement.

ments made necessary after the War of 1812. We had another crisis in 1825. In 1837 occurred the first world-wide crisis. It was brought on in our country largely by the overthrow of the Second Bank of the United States, by overspeculation in land, and by the rapid westward expansion which took place about that time.

Then in 1847 occurred another world-wide crisis. In 1857 we experienced a severe depression, which followed the prosperity due to the discovery of gold in California. In 1873 there took place one of the most severe periods of depression in our history. This was caused mainly by the reckless speculation in railroad building.

The depression of 1884 was of short duration, as was the one in 1890. In 1893 we experienced another severe depression, which lasted four years and caused the failure of many business firms and banks. It also placed the national government in an embarrassing position. In 1903 we passed through what was called the "rich man's panic," which caused only a slight slowing down of business activity. In 1907 there occurred another severe depression which was world-wide in its scope. This was brought on by the failure of several large banks in New York City.

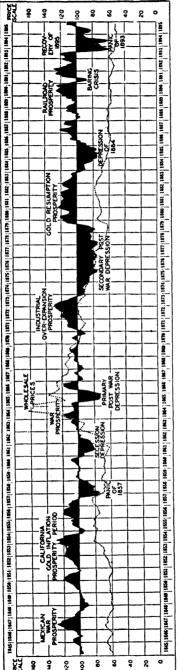
When the First World War broke out in Europe, large sums of money were withdrawn from this country to aid the warring nations. This brought on the decline of 1914. Owing to the fact that we were the only large country that could supply the warring nations with their needs, our business boomed and the threat of depression was removed. After the war, however, we went through a depression in 1920–1921 which caused our commodity prices to fall lower than for many previous years. Following this depression, we experienced one of the most prosperous periods in our history. In 1929, however, there began what many have called the worst depression in our history. It was world-wide and due to the collapse of our foreign investments and to overspeculation in the stock market.

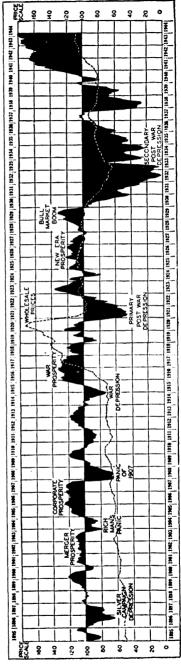
In 1933 it became necessary to close all banks and to take drastic measures to meet the emergency. Congress passed one act after another in an attempt to raise prices, to give employment, and to bring back some degree of prosperity. These measures were not wholly successful, and a large public debt was incurred. A slow improvement began which continued until 1937. After this date another decline set in which was not halted until the outbreak of the Second World War in Europe in 1939. Then, with the prospect that we might be compelled to defend ourselves and with the intention of aiding Great Britain to the extent of our ability, a defense program was inaugurated which caused many lines of business to pick up. This recovery was speeded by our entrance into the war in December, 1941. From that date prosperity prevailed because of the high wages and the employment of everyone able and willing to work. Only the scarcity of goods prevented a genuine prosperity era, but savings deposits increased greatly and billions were invested in war bonds.

This brief survey of the turns of business cycles in our country shows that it is not wise to predict the length of a cycle nor to state that there is any regularity in its occurrence.

Each Period of a Cycle Has Its Own Characteristics.—For convenience in studying the cycle we shall follow the customary practice of dividing it into four periods, known as (1) prosperity, (2) decline or crisis, (3) depression, and (4) recovery. It makes little difference with which period we begin, so we shall start with the period of recovery.

Period of Recovery.—Fortunately, depressions cannot last forever. During a period of depression conditions develop that start business





Courtesy of The Cleveland Trust Company, with acknowledgments to L. P. Ayres

# A CENTURY OF BUSINESS

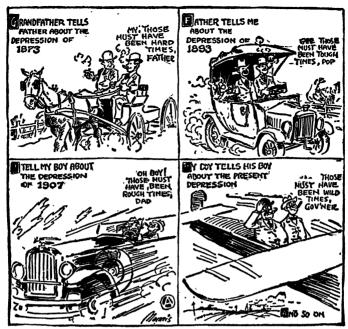
on the road to recovery. Surplus goods have been used up and activity in industry increases; prices are rising and employment is increasing; wages are also increasing which adds to purchasing power; strikes are fewer and bank deposits are growing; interest rates are also rising. All these signs encourage businessmen to go ahead and business in general picks up. Recovery has started.

Period of Prosperity.—As recovery advances, commodity prices rise steadily and more goods are produced; employment reaches a high point and wages are high; purchasing power has been increased by the increase in wages and consumers demand more goods; industrial activity is at its maximum; businessmen are making large profits and banks are making money through high interest rates. With nearly everyone employed at good wages, people are busy and happy. This is called "good times" or prosperity.

Period of Decline or Crisis.—Such conditions should last for a long time, but, unfortunately, they do not. It seems to be true that people in general "can't stand prosperity." When all seems well and everyone is busy, conditions are at work which in the end cause a depression. Part of this is said to be due to human nature and to the desire to make greater profits. When business looks good, businessmen continue to expand production, to operate their plants at full capacity, and to offer high wages to get more workers. At this time, too, strikes become frequent since workers want more money and shorter hours. Industrial activity declines, prices fall, wages drop, and some businesses fail. Employment decreases, which means lower purchasing power and fewer goods demanded. Banks attempt to restrict borrowing by businessmen and speculators by raising their interest rates.

When this stage is reached, bankers become nervous and begin to call for the payment of loans. Some businessmen are unable to make payments and have to go out of business. This brings on what is called a *crisis*. Manufacturers who produced extra quantities of goods hoping to reap large profits, find themselves with a surplus on hand but with their overhead expenses still to be met. This means that they must reduce prices and take a loss. Banks are now in a difficult position, and the stage has been set for a depression.

Period of Depression.—A period of decline or crisis may pass quickly or may last until a severe depression occurs. This happened after the crisis of 1929. A depression is a general stopping of industry, or at



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"IT'S AN OLD STORY"—What lesson about depressions does the artist hope you will draw from this cartoon?

least such a reduction that most industries operate no more than two or three days a week. This means unemployment and suffering for thousands whose incomes have been reduced. During a depression industrial activity is at a minimum, prices are low, wages are low, strikes are few, business failures are many, and interest rates are low.

However, during a depression forces are at work which eventually bring recovery. Again human nature asserts itself. Businessmen find ways to cut expenses and eliminate waste in order to continue in business. Banks accumulate large reserves, which must be lent if the banks are to earn money. So they reduce interest rates. Labor is plentiful at low cost, and the prices of raw materials have declined. These conditions help to bring recovery. Confidence slowly returns, courage begins to be shown by businessmen, and chances are taken. With the appearance of recovery, the cycle starts all over again.

The table on page 441 gives in a condensed form the characteristics of the four periods of the business cycle.

What Causes Business Cycles?—Because of the serious consequences to businessmen and to others, many economists have given

	Prosperity	Decline	Depression	Recovery
1. Industrial activity	High Maximum High Many Few Large Low	Decreasing Falling Decreasing Falling Many Increasing Decreasing Increasing Falling	Minimum Low Minimum Low Few Many Small High Low	Increasing Rising Increasing Rising Few Decreasing Increasing Decreasing Rising

From "Fundamentals of Economics" by Paul F. Gemmill, 3d, edition, p. 327; by permission of the publisher, Harper & Brothers.

a good deal of time and study to the causes of business cycles. Although some of the theories or explanations are interesting, they need not concern us. We shall leave them for the experts to argue about. However, there is one theory which is generally accepted by economists and which is not too difficult to understand. This theory is known as the "self-generating" theory of cycles.

Self-generating Theory.—According to Professor Mitchell, "Business cycles run an unceasing round, each cycle and each period therein growing out of its predecessor and merging into its successor." In plain language this means that each period of the cycle is generated by certain conditions that were developed in the preceding period. In a period of recovery the stock of goods on hand is being exhausted. A time comes when more goods must be produced. Workers are available at low wages, materials may be had at low prices, and it is easy to borrow at the banks. Thus business begins to hum and prosperity to arrive. Now profits are increasing, and so is the desire for still greater profits. Production is expanded, more men are employed, prices are raised, and financial activity also expands. The general attitude of everyone is optimistic. But so much has been produced and so many are eager to sell that the demands of consumers are soon satisfied; business then is not so good. Optimism begins to give way to doubt and only a slight incident is needed to prick the bubble and to bring on a decline. In 1929 the stock market crash was the incident.

Businessmen now begin to curtail production, to reduce the number of workers, and to pay lower wages. The goods on hand must be disposed of and prices are lowered to obtain money to meet expenses. Workers resent the cuts in wages and stage strikes. Purchasing power

is reduced, banks begin to call in their loans and, in an effort to raise cash, goods are dumped on the market at almost any price. The mental attitude of businessmen becomes one of pessimism and fear, and they sit back waiting to see what will happen. This leads to depression.

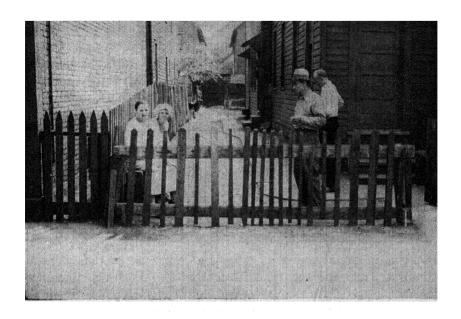
Production has now come to a standstill, and extreme pessimism prevails. No one seems to know what to do to revive business. This situation may last for a long time, but eventually these very conditions lead to the next period of the cycle, the period of recovery.

This is a very sketchy and brief explanation of the self-generating theory but it will prove sufficient for you to see why Professor Mitchell thinks that the business cycle generates itself through conditions in each cycle that bring on the next phase.

Can Anything Be Done to Reduce the Evils of the Cycle?—Whatever one may choose to believe is the cause of business cycles, it is evident that they cause evils that bring hardship to all groups. These changes in business bring uncertainty and fear; gains to some and losses to many others; overexpansion of business and production in good times and failures in hard times; unemployment and loss of purchasing power to workers; and to most of us losses. Can anything be done to lessen these evils? Several suggestions have been made, a few of which we shall attempt to explain briefly.

Stabilization of Production.—The idea is to organize industry in such a way that a steady or stabilized rate of production is maintained all the time. The codes established under the National Industrial Recovery Act were intended to accomplish this and the idea is now operating in the soft-coal industry. But it seems to be evident that this plan can be successful only if carried out under governmental supervision and control. The nation does not seem to be ready for this yet although under the regulations of the war period such procedure was carried out. Whether the plan could be followed in normal times as well as in war emergencies is yet to be proved.

Public Works Programs.—It has been suggested that a more practical plan for government projects be instituted. Those who propose this plan would have the government build its dams, buildings, roads, power plants, and other improvements at a time when business showed signs of slowing down instead of competing in the market for labor at a time when business is booming. This, they claim, would keep people employed and prevent any serious decline in purchasing power. A



Courtesy of Federal Public Housing Authority

PUBLIC WORKS PROJECT—Above is a section of the West Side of Cleveland, known as "The Flats" before the government changed this area through a public works project. After the project had been completed, the same section looked as shown below. Employment was given to hundreds of people who otherwise would have been recipients of charity.



further claim is made that the government would save much money because it would not have to pay such high prices for labor and materials. Our government has spent billions since 1933 on such projects, but it is felt that these expenditures have not solved the problem. Projects must be planned far ahead of the time when they are to be undertaken if they are to be ready when needed. This is difficult as conditions change and a plan drawn up at one time may not be practical a few years later.

Better Business Information.—A further suggestion has been made that the severity of business cycles could be reduced if businessmen had better information regarding prices, credit conditions, the labor market, purchasing power of consumers, and other factors that affect business. It is possible for large corporations to obtain this information, but many smaller industries cannot afford it. Somehow this information should be made available to larger groups than can now obtain it. There are trade journals that publish much valuable information for specific industries; chambers of commerce give much aid to their members. The government publishes several pamphlets and books giving some of this information but it does not reach all those who can profit by it. More might also be done to forecast business conditions. Many statistical organizations analyze current business trends, but they do not forecast. Forecasting docs not always prove successful. But if accurate forecasts of business conditions could be made available, the excessive swings of business cycles might be reduced.

Control of Credit.—Some students of the subject think that depressions are brought about largely because the banks in their eagerness to make money are too liberal in their grants of credit at one time and too strict at other times. Many blame the banks for the situation that developed in 1929. But whatever caused the trouble, those who favor credit control maintain that, if credit can be regulated, the severity of depressions would be reduced. The Banking Act of 1933 permitted banks to decrease loans for speculative purposes by refusing credit to members making such loans. The Banking Act of 1935 created a Federal Open Market Committee, which has complete control of the open-market operations of all Federal Reserve banks, thus adding another check against the overexpansion of credit.

**Summary.**—Business passes through various phases from good times to hard times and back again over a period of years. These

changes are known as the business cycle. Cycles have been occurring at intervals since records have been kept, but no accurate estimate can be made as to the length of the interval between prosperity and depression.

A cycle is divided into four periods: recovery, decline or crisis, depression, and prosperity. When times are good, unemployment is low, prices high, and people feel optimistic; this is a period of prosperity. When the opposite is true, we have a period of depression or hard times. In between these major periods there are periods of decline and recovery.

It is not known for certain what causes these alternating periods, but several theories have been offered as explanations. The one that is most generally accepted is the self-generating theory expounded by Professor Mitchell, who claims that each period of the cycle produces conditions that cause the next period.

Cycles continue to occur, and the problem is how to prevent them or at least lessen their extremes. Many suggestions have been made. Stabilization of production, long-range planning of public works, increased knowledge of business conditions, more accurate forecasts of business conditions, and control of credit are among the suggestions. Each of these plans has merits; all of them together might help if they could be put into actual operation.

#### Questions to Test Your Knowledge

- 1. How do you define a business cycle?
- 2. Name the four periods of a business cycle.
- 3. Give the outstanding characteristics of each period.
- 4. Explain the self-generating theory of cycles.
- 5. What are some of the evils caused by business cycles?
- 6. Does anyone know how long a business cycle will last? why, or why not?
- 7. Mention several suggestions that have been made to correct some of the evils of the business cycle.
- 8. Why is it difficult to make a public-works program succeed in preventing depressions?
- 9. Explain what is meant by stabilization of production.

#### Questions for Discussion and Application

1. How do cycles of prosperity and depression affect (a) wage earners, (b) employment, (c) commodity prices?

- 2. The self-generating theory states that each period of the cycle is the result of certain conditions that have developed in the preceding period. Indicate what some of these conditions are.
- 3 Would we be better off if government took control of business in order to stabilize production? What objections do you see in such a proposal?
- 4. Would businessmen be likely to object to the stabilization of industry? why, or why not? Did they offer serious objections when the codes were in effect under the National Recovery Administration?
- 5. Show how changes in business conditions may lead to depressions.
- 6. It has been proposed that the Federal Reserve banks use their power to control credit so that depressions may be avoided. How can these banks do this?
- 7. "In times of crisis the business world must look to the banks for aid. Upon the ability of banks to extend accommodations as required depends the possibility of weathering the storm." Do you agree with this statement? Why are banks blamed for the fluctuations of business?

#### Floor Talks and Written Reports

- 1. Speculation and business cycles.
- 2. Wartime regulations of production.
- 3. Cycles and world trade.

#### Topic for Debate

RESOLVED, That our competitive system of business encourages the changes in the business cycle.

#### For Further Information

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Gemmill, P. F., "Fundamentals of Economics," Chap. 16.

Hansen, A. H., "The Business Cycle Theory."

Mitchell, W. C., "Business Cycles."

Yoder, D., and G. R. Davis, "Depression and Recovery."

## Chapter XXXIII

# The Quest for Security

#### Aims of This Chapter:

To learn what fears workers have. .

To find out what can be done about unemployment.

To examine several plans to protect old age.

To discuss the Social Security Act.

The preceding chapter stressed the uncertainties of industry due to the changes of the business cycle. Enough has been said to convince you that workers in all types of occupations are constantly beset by certain fears. Their struggle for higher standards of living and for better working conditions is accompanied by many incidents that cause them to lose time and money. The chances of illness and consequent loss of time, the losses caused by layoffs, the chances that they may be "scrapped" while still able to work, and finally, the fear of what may happen to them and their dependents when they become old and are no longer able to work are a few of the things that make the life of most workers a constant worry. This chapter will discuss these needs and tell something of what has been done to relieve them.

Workers Dread Unemployment and Its Consequences.— Unemployment is looked upon as the most serious problem of American industry. It can be defined as the involuntary idleness on the part of workers who are able and willing to work if given a chance. From the point of view of society, unemployment is serious because those who work and earn must support those who are not working but who are willing and able to do so. The money spent in this way does not bring any return to society as a whole. But from the point of view of the worker, the fear of unemployment and its consequences is still more serious. Society may be able to afford to care for the unemployed; but the worker, especially if he has dependents, cannot afford idleness and its results.

The worker who is idle for any length of time becomes disheartened, loses his courage, and sometimes becomes bitter toward a society that cannot provide him with work. If the idleness is prolonged, the worker may become unemployable; that is, he may reach a stage where he cannot work efficiently even if an opportunity offers. He loses his skill and is growing older. Employers pass him by for younger men.

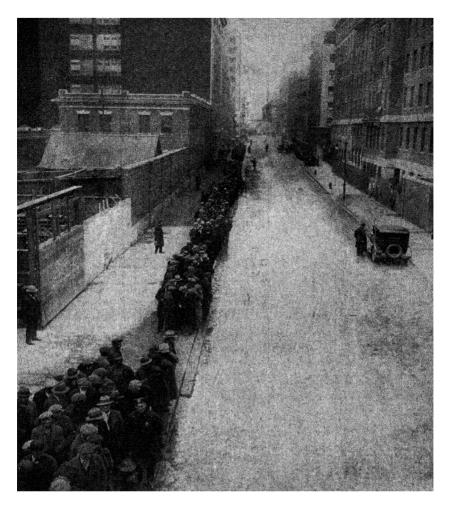
In addition to the bad effects upon workers, there is a great loss of money suffered by the workers and by businessmen because idle people have no money with which to buy goods.

Those who have studied the problem, have found that unemployment is of three types, each of which calls for a different treatment: (1) cyclical, (2) seasonal, and (3) technological.

Cyclical Unemployment.—This type is associated with the changes in business from prosperity to depression and back again. It is connected with the business cycle, and that is how it gets its name. In the preceding chapter you learned that periods of prosperity are characterized by plentiful employment but that, when business suffers reverses and becomes poor, thousands are thrown out of work. The serious period for workers is the period of depression. The more severe and prolonged the depression, the greater the amount of unemployment. This was very evident during the depression of 1929–1935, when it was estimated that between 10 and 15 millions were unable to find work.

The seriousness of cyclical unemployment lies not only in the number out of work, but also in the length of time they are compelled to remain idle. Some depression periods are short, while others may extend for years. Thus workers may be idle for long periods of time, during which they suffer losses of wages and of morale. They also become fearful of the future for themselves and their dependents.

Seasonal Unemployment.—Although many people associate serious unemployment with periods of depression, there is another type which is considered more serious even than cyclical unemployment. This is called "seasonal" unemployment. It gets its name from the fact that at some seasons certain industries employing thousands of workers suffer a decline due to a lack of demand for their product. This necessitates the laying off of many workers. The manufacture of



Wide World Photo

CYCLICAL UNEMPLOYMENT—Here is a scene typical of the depressions days of 1929–1935. Crowds of unemployed are waiting to gain entrance to a lodginghouse set up by the government for their care.

automobiles, some kinds of clothing, the building trades, and mining are seasonal industries. Studies of the clothing industry reveal that the workers average about thirty-two weeks of work a year. It is worse in coal mining, where the workers are said to average about 160 days of work each year. In the case of the building industries it was found that the workers are occupied for only three to five months in the year. Although there are no available figures as to the amount of seasonal unemployment for all industries, it has been estimated that this type of unemployment affects about three million people yearly.



Courtesy of Farm Security Administration, Photo by Lange

MIGRANT WORKERS—These pea pickers, the victims of seasonal unemployment, follow the harvest season from state to state. Most of them have no homes at all except abandoned shacks where they reside temporarily. Our government is striving to improve these conditions.

Technological Unemployment.—This type of unemployment is due to the introduction of machinery and automatic processes that displace men and women. For example, when the cigar-making machine was introduced, it displaced about 30,000 skilled cigar makers. The machine was able to make from 3,000 to 4,000 cigars in an eight-hour day, whereas a skilled worker could make only 300 cigars.

The Research Division of the Federal Reserve Board has estimated that mechanical changes in industry between 1919 and 1929 have increased output per man some 45 per cent and deprived about 500,000 workers of their jobs, at least temporarily.

A similar movement was taking place in agriculture. During those ten years there was a large increase in agricultural output with fewer workers. It is estimated that during this time about  $1\frac{1}{2}$  million farm laborers were forced to leave the farms and seek employment in the cities because of the introduction of farm machinery. The same is true of mining where new machinery has caused thousands of miners to lose their jobs.

What Causes Unemployment?—In describing the types of unemployment we have also stated some of the prominent causes. But these are not the only causes; we shall now describe a few others.

Changes in Methods of Production.—These may be due to the decline of an old industry as when the making of carriages declined when the



Wide World Photo

ONE CAUSE OF UNEMPLOYMENT—When the Chrysler Corporation changed over from making automobiles to making parts for bombers, these men were compelled to learn new tasks or be out of jobs.

automobile came into fashion; the introduction of new types of machinery as illustrated by the cigar-making machine; the relocation of an industry which deprives former employees of work because they are unable to move with the industry. When Mr. Ford changed from the Model T to the Model A, he closed his plant to thousands of workers while the process of getting ready for the new model was going on.

Changes in Consumer Demands.—The old icebox, which required the visit of the iceman nearly every day, has been displaced by the electric refrigerator in many homes, thus depriving some icemen of their jobs. When the use of oil to heat our homes and operate our factories came into fashion, many coal miners were thrown out of work. The cotton textile industry was dealt a serious blow and thousands of workers were deprived of jobs when women took to wearing garments made of rayon and other materials. You will be able to mention many other instances where changes in consumer demands meant unemployment for many workers.

Conflicts in Industry.— Whenever a strike or a lockout occurs, many workers are thrown out of employment until the dispute is settled. Many manufacturers close their plants entirely while a strike is in progress, thus causing employees to lose jobs for an indefinite period.

Can Anything Be Done about Unemployment?—No one today questions the seriousness of the unemployment problem. There have been many suggestions as to how it may be relieved if not solved. We cannot discuss all these proposed remedies, but we shall explain a few of the more prominent.

Better Planning of Production.—It has been suggested that if manufacturers would plan the production of their goods so that there were no seasonal lags, there would be less unemployment. This suggestion has been acted upon by some corporations. One corporation urges its customers to order their products far enough ahead to enable the factory to plan its production upon an even basis throughout the year. Another company undertakes the manufacture of nonseasonal goods in periods when workers would otherwise be laid off.

Another suggestion somewhat along this line is to pay workers upon a yearly basis rather than upon the present hourly basis and to promise the workers a certain number of weeks of work per year. If the work is spread out over a longer period it is thought this can be done.

Better System of Employment Bureaus.—A large number of people believe that many workers who are unemployed could be employed if they only knew where jobs could be found; and that employers could find workers if they only knew where workers were. In other words, our system of bringing the worker in contact with the job is inefficient, so these people say. To remedy this they would establish a system of public employment agencies throughout the country. Unemployed people would register at an agency near them and would be told of opportunities for work because the agencies would have this information through the cooperation of most employers. It is argued that this would be cheaper for the employer and the employee, for no fees would be charged, since the agencies would be maintained at public expense.

In 1918, Congress passed an act establishing the United States Employment Service under the Department of Labor. In 1933, another act was passed which provided that this Service should cooperate with the states in operating a system of employment agencies. The agency is to set up and maintain standards for state employment bureaus, to coordinate the work of these bureaus, and to investigate and report on the employment situation throughout the country. On January 1, 1942, all the nation's public employment offices came under Federal operation so that we now have a national, coordinated, effort to locate and train men and women needed in industry. The service is part of the Federal Security Agency.

Public Works Programs.—It has been suggested that a little more wisdom in planning the building of public projects would do much to relieve the unemployment situation. This was discussed in the chapter on business cycles (Chapter XXXII), when we spoke of remedies for the changes in business. The same objections mentioned there are raised against the plan as a remedy for unemployment.

Unemployment Insurance.—Most Americans are willing to work if they are given the opportunity. When they are forced to be idle, they find it hard to live and support a family. It has been suggested that much could be done to remove from workers the fear of want and to maintain their morale if they could be insured against enforced idleness in much the same way that they are insured against accidents while at work. This is called "unemployment" insurance.

Several objections have been made to unemployment insurance. It is said that if a worker knows that he will receive a



DESPAIR—This young man is out of work. He has tried to find employment but in vain.



EXPECTATION—He finally goes to the Federal Security Agency and registers for a job.



Courtesy of Federal Security Agency

A JOB AND HAPPINESS— The Federal Security Agency has aided him in locating a a good job and he is now busy and happy. certain amount of money when he is idle, he will make it a point to remain idle. Another objection is that it will discourage thrift and foresight on his part. The answer to the first objection is that the amount received by the idle worker is much less than he would receive if he worked, and in any case it would not be enough to enable him to live in any comfort; therefore, he will try to find work as soon as possible.

In 1935 the Social Security Act was passed, which contained a provision to insure workers against unemployment. The unemployment sections of the act are administered by the states through their own plans, which must first be approved by the Social Security Board. All forty-eight states now have approved laws. The plans are fairly similar and are supervised by the Federal government. The funds are obtained through a tax on pay rolls which is paid entirely by employers in most instances. This tax is now 3 per cent; it is paid to the Federal government, but 90 per cent of it is returned to the states where collected if they have satisfactory unemployment compensation laws. Benefits are paid to employees under certain conditions when they become unemployed. They usually amount to about half the wages earned when employed; in most states the maximum is \$15 a week and the minimum is \$5 a week. The benefits are paid over a period not exceeding sixteen weeks in most cases.

Desire for Security against Long Hours and Low Wages.— When the factory system was first established, there was no thought given to the number of hours a workman could toil without injury to his health and efficiency. Days of twelve and fourteen hours were not unusual. There were no laws that provided for working hours for men, although later there were some for women and children. Only through collective bargaining have workers been able to have working hours reduced. The struggle has been long and bitter.

By 1880 the working day had been reduced to ten hours. But it took forty more years to reduce it to nine hours a day. It took nearly ten more years to get the eight-hour day. This meant a forty-eight hour week. However, in many industries there were still shifts of more than eight hours, and a fifty-four- or even a sixty-hour week was not uncommon. In 1933, the codes under the National Recovery Act provided for a forty-hour week in many industries and a thirty-five- to thirty-six-hour week in others.

In 1938, Congress passed the Fair Labor Standards Act, better known as the Wages and Hours Law, which, among other things, established a basis for a fair working week.

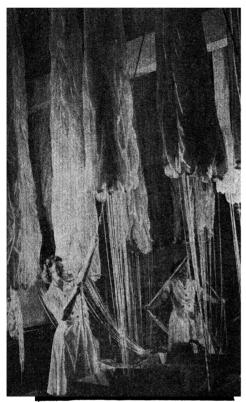
The act sets a limit to wages at the bottom and to hours at the top in all industries engaged in interstate commerce; this means practically all industries today. The law provides for a maximum forty-hour week, which is in effect at the present time; and for a minimum hourly rate of 40 cents by 1945. Many industries are paying this rate now. Overtime work is permitted, but workers are entitled to receive compensation at the rate of not less than one and one-half times the regular rate for all hours in excess of the maximum permitted by law.

Security for Women and Children.—Not only have workers been interested in obtaining economic security for themselves; they have been anxious to free their wives and children from long hours of toil under unhealthful conditions. Like the other struggles, this, too, has been a long and bitter one.

Child labor has existed in the United States since before the industrial revolution. It is found in several industries and in agricultural fields. Children have also been employed in domestic service, street trades, stores, messenger service, and tenement homework. These children are often put to work before they have had much schooling because their parents are not able to earn enough to support the family. Public indifference has been another reason why child labor has existed for so long. The factory system with its division of labor and use of machines has made possible many tasks that can be performed by children at small cost and thousands of them have been employed under poor working conditions.

It has not been easy to regulate child labor; many states have laws forbidding or restricting it, while many others have no regulations at all.  $\Lambda$  Federal law seemed to be called for if anything on a large scale was to be accomplished. But attempts of the Federal government to regulate child labor by law were declared unconstitutional by the courts. An amendment to the Constitution that would permit Congress to regulate child labor has not yet been approved by the required number of states.

In 1938, the Wages and Hours Law decreed that after October, 1938, it would be illegal to ship in interstate commerce any goods produced by any person less than sixteen years of age, or less than eighteen years of age when the Childrens' Bureau of the Department of Labor should decide the occupation to be dangerous. There are some exceptions to the law, but in general it has done much to abolish child labor in the country.



Courtesy of Office of War Information, Photo by Rittase

WOMEN IN INDUSTRY—The Second World War threw industry wide open to women. The girls above are testing parachutes which have already been put through a test flight. A certain percentage of all parachutes produced are dropped from planes, then returned to the plant for inspection.

Women in Industry.-Women have always been engaged in industry, but the problem has been made more acute by the great additions in recent years to the number of women who have sought to earn their own living. According to the census for 1940. there were over 13 million women engaged in gainful occupations in the United States. Of this number over 4 million were married. During the Second World War 18.7 million women were occupied in industries. This number will be greatly reduced as soon as normal times arrive, but many of these women will want to engage in some kind of gainful work.

The problem of women in industry is not to prohibit their labor but to regulate it in order that women may work under conditions as good as those under which men work. Many states have passed laws to safeguard women in industry. The number of hours which they may work has been reduced to eight in many states. Some states prohibit night

work for women in industrial plants. Other provisions have been made to protect women who work. It is now thought that the security of women in economic life is nearly as well provided for as that of men.

How Can Workers Be Insured against Accidents and Sickness? It is well known that many workers lose precious time and money because of inability to work at times owing to accidents and sickness. They feel that their troubles are due to conditions under which they work and not wholly to their own fault. Accordingly, they have striven to have laws passed that will insure them against some of the loss due to these circumstances.

It was not until 1910 that compulsory insurance against industrial accidents became common in most of our states. Since that time the movement has grown rapidly. At the present time nearly every state has some form of insurance against accidents sustained by workmen while performing their work. Although the laws of these states are not uniform, in general they provide for the same things.

Workmen's compensation acts provide that the employer is liable for every injury sustained by an employee as a result of an accident "arising out of and in the course of his employment." They also provide that all injuries shall be compensated for in accordance with definite schedules. Employers are required to deposit bonds, to maintain insurance funds, or to contribute to funds for this purpose maintained by the state, in order to assure that all such payments will be made. All plans require a waiting period, in order to eliminate claims that might arise from slight injuries. None provide more than part pay in case of disability.

These laws have done much to improve the mental state of the worker, when injured in industry. He knows his family will receive his wages for a time, that his doctor's bills will be paid, and that, in case he is killed, the family will receive a sum sufficient to care for it for a while. The idea is that, when the burden of loss due to accidents is placed upon the industry itself, the employers are more likely to make every effort to prevent or to reduce them.

Health insurance of a compulsory nature has not yet been adopted in the United States although it has been quite common in Europe. Many employers have insured their employees as a group in a commercial insurance company. So far this is the only form of health insurance that exists for the worker unless he wishes to provide it for himself.

Security against Dependency in Old Age.—One of the greatest fears that beset most of us is the dread of arriving at the age when we can no longer work and finding we have nothing upon which to live. The problem of what to do about this has been growing more and more prominent in the past two decades. Studies have been made which show that our population is undergoing some significant changes. More people are living beyond the age of sixty-five and our population contains a larger percentage of old people than ever before. According to the fourth annual report of the Board of Trustees of the Federal Old Age and Survivors Insurance Trust Fund there were in 1940 about 9 million aged sixty-five and over, which was

6.8 per cent of the total population. By 1980, this number may increase to about 22 million, or 14.4 per cent of the population. Most of these people have no means of support, and the great depression made it impossible for children to care for their aged parents. These facts led to the proposal of several plans to provide for old people. Two of these plans gained much prominence.

Townsend Plan.—Dr. F. E. Townsend of California brought forward a plan during the depression years of the 1930's which would pay a pension of \$200 a month to all who reached the age of sixty and who were unemployed. The money to support the plan was to be raised by a 2 per cent tax on all commercial transactions. Although the Townsend Plan supporters claimed many advantages for their plan, and gained thousands of followers among the aged, it was defeated by a large majority when it came before Congress in 1939. The plan was later altered to one proposing to pay \$60 a month to all unemployed over sixty.

\$30 Every Week Plan.—This plan also originated in California. It was a plan to add an amendment to the state constitution which would permit the payment of a "pension" to every person over fifty "who is unemployed or who voluntarily quits his employment, and who does not employ others to produce goods or services for hire or sale." Under the plan the state administrator would issue, every Thursday, \$30 in the form of warrants to those entitled to receive them. These warrants could be used to purchase commodities and services when at each transaction a 2-cent state stamp was affixed to them. At the end of the year the warrant, which must have \$1.04 in stamps on its back, would be returned to the state and redeemed for \$1 in United States currency. The proposal created much interest and excitement, but it was defeated. The sponsors claimed that they would continue their campaign.

Several other plans were proposed to lessen the trials of dependent old age. None of the plans seemed practical, but agitation increased and it was considered wise to call upon Congress to work out a nation-wide plan.

What Does the Social Security Act Provide?—In 1935, Congress responded with the Social Security Act, which set up a Social Security Board of three members appointed by the President for a term of six years. This Board is responsible for the operation of the act.

The act covers many fields, such as unemployment insurance, and old-age and survivors insurance; public assistance programs, including aid to the aged, to the blind, and to dependent children; maternal and child health services; services to crippled children; child welfare services; vocational rehabilitation; and extension of public health service. The old-age and survivors program is administered wholly by the Federal government. All the others are administered in cooperation with state agencies. Space does not permit us to discuss all these agencies, but we shall describe



Courtesy of Social Security Board

OLD-AGE ASSISTANCE—This elderly couple are receiving old-age assistance under the Social Security Act. The young welfare worker calls on them to see how they are getting along and if they need any special help.

briefly the two programs that provide for aged persons.

Old-age Assistance.—One section of the act provides financial assistance to needy persons over sixty-five years of age. The Federal government contributes on a 50-50 basis with each state, up to a maximum of \$20 per month, or a joint pension of \$40. Of course, if the state wishes to pay more than \$20, it may do so; or it may pay less. But in no case is the Federal government permitted to contribute more than \$20 per month per person. This provision takes care of those aged people who cannot work but who are in need of assistance.

Old-age and Survivors Benefits.—Another section of the act established a system of old-age and survivors monthly benefits which is operated by the Federal government. Under the terms of the act both the employee and the employer must contribute to a national reserve fund out of which the benefits are paid. A tax is levied on the wages of the employee, which is deducted from his pay by the employer and sent to the Bureau of Internal Revenue in Washington, D.C. The employer adds an equal amount. This tax at present amounts to 2 per cent of income, 1 per cent paid by the employer and 1 per cent by the employee.

The amount of benefit that the worker will receive at sixty-five is based upon his average monthly wage during the period of his employment. The protection to workers has been increased through



Courtesy of Social Security Board

SECURITY IN OLD AGE—This smiling elderly couple have just received their first Old Age and Survivors Insurance check from the Social Security Administration. A similar check will come to them each month as long as they live.

a provision which gives additional benefits for dependents. Thus, a worker receives an additional monthly benefit for his wife if, or when, she becomes sixty-five years old. In case the insured worker dies, benefits are provided for the widow, if she is sixty-five or if she has minor children to care for, and for such children themselves. If the worker is single and leaves dependent parents, the parents receive a benefit in the form of a pension. Thus the family is recognized as the basic social unit rather than the individual. This provision has added greatly to the security of the worker and his family and has relieved him of one of his greatest fears.

Summary.—Laborers have carried on a long struggle to better their conditions and to make their

economic life more secure. They have been constantly beset by certain fears, which they wish to have removed as far as possible. One of the greatest of these fears is that of being unemployed and unable to provide for their dependents. Although much has been done to remedy the unfortunate conditions due to unemployment, the problem is still a major one and its solution is still in the future.

The desire to have hours of work reduced and a definite minimum placed upon wages that must be paid has been satisfied to an extent by passage of the Wages and Hours Law and by legislation in many states. Likewise the problem of child labor and work by women in industries has been attacked and some relief has been found in several Federal laws and in many state laws. As a result, child labor is practically ended in many industries and women are protected against exploitation.

Fear of loss of income through injuries received while at work and the expense attached to medical and hospital expenses sometimes incurred because of accidents, has been reduced through workmen's compensation acts now effective in all the states. Not much has yet been done to relieve the workingman from loss through sickness except as individual industries choose to adopt and operate plans of their own.

Insurance against dependency in old age has been provided in the Social Security Act, which provides financial assistance to the needy through a cooperative plan administered by the states but aided by the Federal government. It also provides a system of monthly benefits to all who reach the age of sixty-five and retire from active employment. In addition to these provisions for the aged, there are sections of the act that provide through state cooperation for assistance to dependent children, to the blind, to dependent mothers, and to others.

The struggle for economic security is not ended but steady progress is being made toward security against the risks of industry and old age. Already proposals have been made to extend the Social Security Act to millions who are not now protected by its provisions and to increase the amount of benefits to be paid.

#### Questions to Test Your Knowledge

- 1. What are some of the things that cause workers to feel that their economic conditions are not secure?
- 2. How is unemployment defined?
- 3. Name and explain each kind of unemployment.
- 4. List other causes of unemployment.
- 5. What has been suggested to remedy the unemployment problem?
- 6. Why is it not easy to abolish or regulate child labor?
- 7. How do workmen's compensation laws operate?
- 8. What was the purpose of the Social Security Act?
- 9. Explain how old-age assistance operates.
- 10. How is the money for old-age benefits obtained?
- 11. Who receive benefits under the Social Security Act?
- 12. What is the basis for determining how much a worker shall receive at the age of sixty-five?

#### Questions for Discussion and Application

1. Which of the causes of unemployment do you consider the most serious? Give reasons for your answer.

- 2. Which of the proposed remedies for unemployment do you believe will prove most effective in relieving the problem? Give reasons.
- 3. What effect might the introduction of more machinery on farms have on employment? on the price of farm products?
- 4. If farmers could raise more crops at less cost and thus earn more, would it not be wise for farmers to use more laborsaving machinery?
- 5. Examine the sections of the Wages and Hours Law that have to do with the labor of children. Is all child labor prohibited by the act? What, if any, exceptions are made?
- 6. Discuss the changes in population trends and in industrial methods which make old age a serious problem.
- 7. Are the fears of workers regarding economic conditions and their effect on the future of the workers justified? Discuss.
- 8. Do you believe that laws reducing hours of work and fixing a minimum wage are beneficial to workers in the long run? Discuss.
- 9. Some object to the *compulsory* contributions of part of their wages by employees. Would a voluntary plan work better? What might happen if the plan were made voluntary? Is compulsion in this case a violation of any democratic principle? Discuss.

#### Floor Talks and Written Reports

- 1. Public vs. private employment agencies.
- 2. Old-age pensions.
- 3. Extension of social security.

#### Topic for Debate

RESOLVED, That the Federal government should guarantee all workers against want in their old age.

#### For Further Information

Building America, "Social Security," Vol. II, No. 4.

Burns, E. M., "Toward Social Security."

Douglas, P. H., "Social Security in the United States."

Francis, B. H., "What Will Social Security Mean to You?"

Harris, S. E., "Economics of Social Security."

Public Affairs Pamphlets, "Who Can Afford Health?" No. 27; "Security or the Dole?" No. 4; "Pensions after Sixty," No. 46; "Freedom from Want," No. 80; "Jobs and Security for Tomorrow," No. 84; "Should Married Women Work?" No. 49; "Man Meets Job," No. 57.

Social Security Board Pamphlets and Reports.

#### PROBLEM 35

#### Social-security Benefits

The formula for working out social-security benefits is as follows: Take 40 per cent of the first \$50 of average monthly earnings; to this add 10 per cent of any monthly earnings over \$50 and up to \$250. This will give the basic benefit. Take 1 per cent of the basic benefit; multiply it by the number of years in which the worker earned more then \$200; add the result to the basic benefit. This will give the monthly pension which the worker will receive after he retires.

Assume that William Plodder was thirty years of age when he began work under the Social Security Act and that he worked continuously until he retired at the age of sixty-five. His average monthly wage for the time covered by employment was \$160.

Using the formula given above, find the monthly pension Plodder will receive when he retires at sixty-five. Plodder is unmarried and has no dependents.

- 1. Will this pension be sufficient to provide Plodder's wants when he retires, assuming that this will be his entire income?
- 2. What situations might have occurred during Plodder's working days that would lower his retirement pension?
- 3. If Plodder had died any time before sixty-five, what would have been done with the money he had paid in from his wages?
- 4. What does this problem show regarding the need for saving something over and above social security payments?

### Chapter XXXIV

# Cooperation and Thrift

#### Aims of This Chapter:

To learn what consumer cooperatives are.

To discover the principles of cooperation.

To find out how cooperatives originated.

To examine several types of cooperatives.

To learn how cooperatives aid consumers.

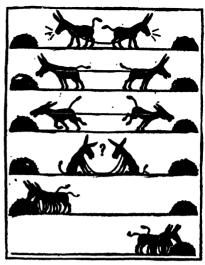
Consumers are not wholly satisfied with the methods by which they are obliged to buy the goods they need. They feel that they pay too much for many of the things they buy and that the marketing processes and principles favor producers and retailers more than consumers. As a result, many consumers have given much thought to other methods of buying goods. They have developed a new method of organization in an attempt to lessen the handicaps that exist for them in the present system. These organizations are called "consumers' cooperatives." They offer a method of cooperative buying by which consumers may save money and still obtain quality goods. This chapter will be devoted to an examination of cooperatives in general and of consumers' cooperatives in particular.

What Are Consumers' Cooperatives?—These have been defined as associations of groups of individuals in the conduct of a business enterprise for the purpose of securing for themselves advantages as consumers through collective effort.

Principles under Which Cooperatives Operate.—Consumers' cooperatives operate under certain definite principles. Since these principles have served with slight variations as the basis for practically all consumer cooperatives, they will be outlined briefly.

- 1. Membership is on a voluntary basis and open to everyone.
- 2. Each member has only one vote no matter how many shares he may own or how much money he has invested in the association.

- 3. No member may own more than a small number of shares; that is, the stock ownership is limited. The rate of return on the capital investment is low and fixed.
- 4. Goods are sold at prevailing prices on a strictly cash basis.
- 5. Profits, when they are realized, are distributed in proportion to purchases of members at the store and not in accordance with ownership of shares of stock as in a private business. Patronage refunds are made at designated periods.
- 6. Sums must be set aside for education in cooperative principles.
- 7. Merchandise of quality is sold with honest weights and measures.



COOPERATION—Tell the story in your own words.

What Are the Characteristic Features of Cooperatives?—Certain features of cooperatives should be mentioned because the success or failure of the enterprise depends upon them. The employees are usually members of the association and so are more likely to give their best to the enterprise; there are few labor troubles. Fair wages are paid, reasonable hours are required, and working conditions are satisfactory. Some cooperatives hire a manager who is not a member to run the business but the officers of the cooperative supervise his activities.

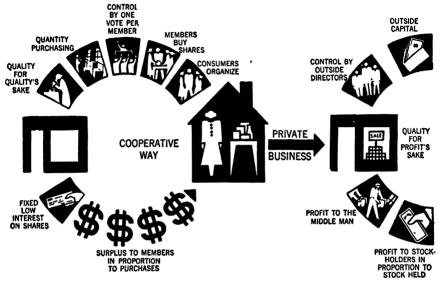
Cooperatives are subject to the same risks as other businesses. They are subject to periods of prosperity and depression. But cooperatives, when properly managed, set aside a substantial reserve fund with which to tide them over the period of poor business.

Cooperatives work with one another. Each consumers' cooperative is affiliated with other retail cooperatives in wholesale cooperatives. These retail and wholesale cooperatives are in turn affiliated with the Cooperative League which extends throughout the nation. Thus each is able to benefit by the experience of the others.

How the Cooperative Movement Developed.—Many think the cooperative idea is something new. As a matter of fact, it has existed in some form for many years. History contains many instances

## CONSUMERS Cooperative

## PRIVATE Business



From Maxwell S. Stewart, "Debts-Good or Bad?" Public Affairs Committee, Inc., New York

of cooperatives. But our interest is in the modern phase of cooperation.

The modern phase of cooperatives is said to have originated with the weavers of Rochdale, in 1844. In this little English village the weavers were hard hit by the depression and suffered great hardships because they had so little to spend and found it difficult to get what they needed. One of their number suggested that they pool their limited savings and purchase groceries together. Twenty-eight weavers agreed to the plan and for one year they saved all they could. At the end of the year they had £28 (about \$140). With this small sum they fitted up part of an abandoned warehouse as a store and laid in a supply of goods. They adopted the principles mentioned at the beginning of this chapter and started business. At first they were laughed at by many who considered them foolish. But they persisted. Gradually new members were added and the society began to add new lines of goods. In time they opened up branches and increased their business. The movement grew, spreading in time to Denmark, Norway, and Sweden, where from 30 to 40 per cent of the families

belong to cooperatives. Soon practically every country in Europe had consumer cooperative organizations.

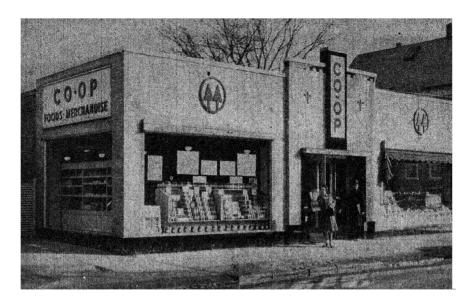
Cooperatives in the United States.—Not long after the Rochdale experiment, the cooperative movement appeared in the United States. The first cooperative of which we have any clear record was called the New England Protective Union, which at one time claimed 400 members. This was before the war between the states, which it was unable to survive. After the war, attempts were made from time to time to revive the idea but people did not take to it as they had in Europe.

There were several reasons for this lack of interest. For one thing, the early immigrants came to the United States chiefly to obtain some of the wealth which they were told existed here. Each individual or family worked for itself and did not consider cooperation essential. They aided one another in erecting houses and in working the farms, but they did not enter into cooperation in buying and selling. Although large areas of undeveloped lands existed and natural resources were plentiful, people paid little attention to saving or economizing.

Another reason why cooperatives have been slow to develop in the United States is the growth and improvement in chain-store selling. These chains are patronized by many consumers who under some circumstances might join a cooperative.

The depression which began in 1929 gave a great impetus to cooperatives and since then they have grown rather rapidly. When unemployment is great and incomes are reduced, people seem to be ready for cooperation. This proved to be true here in the United States. By 1933, according to the Department of Labor, there were 695 local consumers' cooperatives with a membership of 225,000. About 90 per cent of these cooperatives were found in retail lines dealing in general merchandise, gas, oil, and fuel. They did a gross business estimated at 40 million dollars and returned about a million dollars to members as their share of the profits. Since 1933, the number of new cooperatives has increased to over 5,000 with an estimated membership of one million.

Cooperatives Are of Different Types.—Cooperative organizations are of many kinds and usually appear in those fields in which consumers can obtain savings. These include retail marketing of groceries, gasoline, oil, and fuel; supplying credit to consumers;



Co-op League Photo

RETAIL COOPERATIVE STORE—In many communities scattered throughout our country are stores similar to the one pictured here. These stores enable consumers to purchase quality goods at regular prices and receive a dividend at the end of the year, thus reducing the cost of their goods.

health; and the production of goods. Each of these will be discussed briefly.

Retail Merchandising.—Most cooperatives are found in retailing. It is in these fields that the greatest savings are possible and the least capital is required. If the cooperative is to succeed, it must depend upon the loyalty and patronage of its members. If members do not buy in sufficient amounts, the enterprise fails. This has been one of the most serious problems cooperatives have had to meet.

To form a retail consumers' cooperative, the consumers form a stock company, subscribe for shares, which are usually \$5 each, draw up a set of bylaws, employ a manager and clerk, and start business. The profits are then divided among the members in proportion to their purchases. In this way the members are able to obtain their goods at a lower cost and at the same time be assured of good quality.

Advantages.—Several advantages are claimed for consumers' cooperatives: (1) The members receive a larger share of the profits than they would get if they had no such association. (2) There is less chance of deception in the matter of weights and labels. Goods in a cooperative store are sold to owners and customers who are interested in its welfare. (3) Much of the waste of the present system of selling



Co-op League Photo

A WHOLESALE COOPERATIVE—This wholesale cooperative, and others like it, supply the retail cooperatives with all kinds of goods. Not only do they supply the regular brands of goods but they also deal in their own special brands.

goods is eliminated. There is no high-pressure salesmanship to sell goods and the customers see what they are getting.

Disadvantages.—There are a few disadvantages that accompany businesses of this type: (1) They suffer from a lack of capital and from inefficient management. (2) They suffer from a lack of interest among members. (3) In times of depression, when prices are declining, consumers' cooperatives are sometimes placed in a difficult position.

Wholesale Cooperatives.—Some private wholesalers refused to sell to the retail cooperatives. This placed the retail cooperatives in a difficult position, but they met the situation by establishing wholesale organizations of their own. Many of these have now been set up, and the local cooperatives are able to obtain their goods without trouble. They have produced their own brands and have their own distribution system.

Cooperative Marketing.—This type of cooperative is found chiefly among farmers and fruitgrowers. The purpose is to eliminate as many middlemen as possible and to secure greater efficiency and economy in



Courtesy of Resettlement Administration, Photo by Rothstein

FARMERS COOPERATE—This farmer is signing an agreement to enter the Farmers' Production Cooperative, which will help him to market his crops, purchase seeds and fertilizer, and incidentally increase his income.

distributing products. The individual farmer is rarely able to sell his goods directly to consumers. Furthermore, the farmer has little bargaining power by himself; he does not have the facilities for storing his crops until he can dispose of them. Faced with these difficulties, farmers have organized cooperatives in order to sell their products to the best advantage. Marketing cooperatives are found among the fruitgrowers of the Pacific Coast; the California Fruit Growers Association is nationally famous. Such cooperatives are also found among the milk producers of New York and other places.

Producers' Cooperatives.—These are organizations of workers who combine their resources and abilities to carry on an occupation. The workers own and control the industry and thus eliminate the business enterpriser. Each worker receives wages in accordance with an adopted scale and, in addition, a share of the profits. This means that each worker does his best in order to make the business a success.

Producers' cooperatives have not been altogether successful. There are several reasons for this. It is difficult to obtain enough funds to operate and expand the business; many of the members lack business ability, and paid managers do not always have the interests of the business at heart.

Credit Unions.—For some time consumers have felt the need for less expensive credit facilities. This has led to the formation of credit unions. A credit union is a cooperative savings and loan association, organized within a specific group of people, and limited in its operations to that group, self-managed and functioning under the state banking laws.

A credit union has two main purposes: (1) to supply its members with an easy and convenient system for saving money and (2) to make it possible for members to borrow money at low rates of interest. Members buy shares or deposit as much cash as they choose. This money is pooled and lent to the members. The loans are for short terms.

To join a credit union a person buys at least one share, which usually costs \$5. Only members can get loans. However, a person may join at the time he makes application for a loan.

Laws generally set the top limit for loans without security. The Federal law at present allows Federally chartered credit unions to lend no more than \$50 on the unsecured note of a member. A common form of security is the signature of one or more cosigners or indorsers who are members and who agree to make good should the borrower fail to meet his note. The most common rate of interest among credit unions is 1 per cent a month on all unpaid balances.

Members may save money through the credit union by depositing part of their wages. This money earns dividends that are generally higher than those paid by savings banks.

The credit union movement in the United States is a consumers' movement. All but six of the states now have laws permitting them to be formed. The Federal government began issuing charters to credit unions in 1934. There are now over 3,300 Federal credit unions and over 4,300 state-chartered credit unions in existence.

Cooperative Medicine.—Many consumers' cooperatives have established medical services for their members. The medical department is under the control of the board of directors or of a special committee. Some of these societies establish medical service free for all members, financed by the surplus savings of the cooperatives. Others set up a separate medical department and require the member to make a payment for the service. These organizations often provide not only medical care but sickness and death benefits.

What Do Consumers Gain from Cooperation?—Several forms of cooperation have been described. All of them were organized to

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serve some need of consumers. It was hoped that, by cooperating, consumers would eliminate many of the charges made by various middlemen and would thus obtain goods more cheaply. This hope has been realized in the consumers' cooperative that is well managed and has the loyal support of its members. In other cases consumers desired to obtain funds at more reasonable rates. This has been accomplished through the credit unions. Other forms of cooperatives have aided farmers and other producers to reduce the costs of marketing their goods and have enabled them to obtain more profits for themselves. In general, it may be said that cooperation has enabled consumers to obtain commodities and services at a lower cost and of better quality.

Summary.—Because some consumers have been dissatisfied with the methods under which they are obliged to buy commodities and services, there has developed a new method of organization called consumers' cooperatives. These cooperatives operate under certain definite principles which were laid down by the Rochdale weavers in 1844. They are democratic in organization and principle. Anyone may become a member by buying at least one share at a nominal price. All members share proportionately in the profits. Control is in the hands of the members through a board of directors elected by them. No member has more than one vote no matter how much he may have invested.

The modern cooperative movement began in England and soon spread over all Europe and to the United States. Growth in the United States has been slow because of the prevalence of chain stores. During recent years the cooperative movement in the United States has developed more rapidly so that now there are thousands of such cooperatives with more than a million members. Cooperatives are of many kinds and exist in almost all fields where consumers can save money. No matter what the type, all cooperatives try to eliminate middlemen and to reduce the cost of commodities and services to members. When these associations are well managed and loyally supported, consumers are enabled to obtain goods of better quality at lower prices.

### Questions to Test Your Knowledge

- 1. What are consumers' cooperatives?
- 2. Enumerate the principles under which cooperatives operate.

- 3 When did the modern period of cooperation begin?
- 4. Tell the story of the Rochdale Cooperative Society.
- 5. Why have cooperatives grown so slowly in the United States?
- 6. List the advantages and disadvantages of consumers' cooperatives.
- 7. What is a credit union? State the purpose of credit unions.
- 8. Explain how producers' cooperatives operate.
- 9. What are the chief advantages consumers obtain from cooperatives?

#### Questions for Discussion and Application

- 1. The consumers' cooperative movement has been called socialistic. Examine its principles and see if you can find any reason for this charge.
- 2. Discuss the reasons why cooperatives have been more successful in England and the Scandinavian countries than in the United States.
- 3. Give several reasons why consumers' cooperatives usually succeed while producers' cooperatives often fail.
- 4. Is there anything inherent in consumers' cooperatives and their principles which would give them advantages over other types of business?
- 5. If there is a credit union in your community, investigate it and make a report of your findings to the class.

#### Floor Talks and Written Reports

- 1. The Associated Hospital Plan.
- 2. The story of credit unions.
- 3. Why consumers cooperate.

#### Topic for Debate

RESOLVED, That consumers' cooperatives meet a need not supplied through the ordinary channels of retail business.

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### Chapter XXXV

# Competing Economic Systems

#### Aims of This Chapter:

To learn what capitalism has done for us.

To examine the criticisms of capitalism.

To discuss the program of socialism.

To see what communism proposes.

To find out what fascism is and does.

To this point in our study of economics we have been describing the economic system under which we live. You have learned many things about the production and consumption of goods and the manner in which the national income is shared. Your study of labor problems showed you that there is much dissatisfaction with the present method of sharing income. Laborers feel that they do not get enough. Many other groups are dissatisfied with the economic system under which they live and work. This dissatisfaction with things as they have been exists all over the world and has been increased by events and conditions brought about by the recent war. Several economic systems have been developed which claim to improve the living conditions of their people. We shall have space to consider only the four most prominent systems: capitalism, socialism, communism, and fascism.

What Is Capitalism?—The capitalistic system, or capitalism, has prevailed in the United States ever since we became a nation. It has been defined as an economic system in which industry is organized and conducted for profit by private enterprise.

Capitalism as an economic system is based upon certain fundamental institutions with which you have already become familiar (see Chapter I). These institutions are competition, the profit motive, private property, individual initiative, freedom of enterprise, and the right to enter into agreements. Capitalism maintains that individual

initiative and independence furnish the best incentive for industrial progress. Under this system the individual is respected; he may engage in any activity or conduct his business relatively free from governmental interference.

This policy of noninterference by the government has been called laissez faire. But there has never been a time when there has not been some regulation of individuals and industry by government in the interests of society. You have learned about several agencies whose function is to regulate some part of industry. Among these you will recall the Interstate Commerce Commission, the Federal Trade Commission, the Federal Communications Commission, State Public Service Commissions, the National Labor Relations Board, and the Social Security Board. During the Second World War hundreds of agencies were set up which regulated and controlled almost every activity of business and living. Prominent among these agencies were the Office of Price Administration, the War Labor Board, and the Office of Defense Transportation.

What Has Capitalism Accomplished?—The fact that capitalism has existed as long as we have been a nation and still exists indicates that it must have good features and that it must have brought benefit to the people of our country. And this is true. There have been many benefits from capitalism. We shall list briefly the achievements credited to this economic system.

Probably the first achievement that many would list is that it has made possible the highest standard of living that exists anywhere in the world. This has been brought about through the production of great quantities of wealth which has been shared more or less by all classes. The accumulation of large amounts of capital has made possible the many luxuries and conveniences we enjoy today.

Second, private enterprise, with the use of accumulated individual savings, has given us railroads, automobiles, steamships, telephones, radios, central heating plants, modern homes, electric lighting, modern office buildings, apartment houses, hotels, moving pictures, and many other conveniences that are now within the reach of the masses. The quality and amount of goods available to the masses have been on a scale larger than ever before. Although some of capitalism's methods may have brought distress and want to many, it is claimed that under no other economic system are the people in general so well off

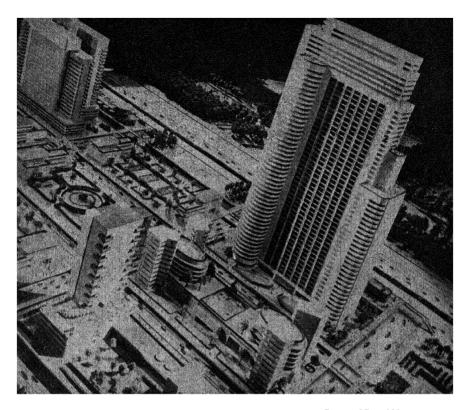


Courtesy of Westinghouse Electric and Manufacturing Company

THE TIME CAPSULE—These gentlemen are packing the Time Capsule, which was buried fifty feet deep on the grounds of the New York World's Fair. It is to endure for 5,000 years. The capsule is a metal cylinder containing thirty-five articles of common use and a microfilm record equivalent to 10 million words of printed matter. It is an 800-pound "letter to the future" addressed to the people of A.D. 6939. On the table are the articles that are to go into the capsule to show the people 5,000 years hence what our civilization and culture were like.

A third achievement credited to capitalism is the reward which it offers to individual initiative and ambition. In a capitalistic society men are free. Whereas all do not have the same ability nor the same opportunity, everyone is free to invest his time and energy as he sees fit. It is claimed that the possibility of gaining profits spurs men on to greater achievements. Society offers rewards to those who develop initiative and business ability. It is in the so-called "capitalistic" nations that are found the largest individual fortunes and the greatest number of rich persons.

To sum up, we may say that it is claimed for capitalism that it has made us a richer and more influential nation, that it has given us



Courtesy of General Motors

THE CITY OF THE FUTURE—This is a photograph of a section of the city of the future as depicted at the New York World's Fair. Note the type of buildings for offices and apartments and the open spaces for parks and avenues. How does this compare with the crowded cities and streets like canyons of the present?

higher standards of living and more diversified activities than any noncapitalistic nation.

What Is Wrong with Capitalism?—But great as are the economic gains under capitalism, it has come in for some serious criticisms. Let us examine some of them briefly.

It is said that capitalism is wasteful of resources and man power. There is waste in the production of goods, as you have seen, when more of some things are produced than people can consume at the time. It is not uncommon to have goods produced that no one wants. Critics claim that the profit motive leads to inefficiency in production and to the production of goods that may not be of much use to the greatest number of people. Thus it is said that capitalism is without any plan for production or distribution of wealth.

One of the severest criticisms of capitalism is that it results in a

very unequal distribution of wealth. Although great quantities of wealth are made possible in a capitalistic system, the people who seem to profit most are those who already possess much wealth. At the top are a few very wealthy people who exert great influence on economic and political affairs while at the bottom are masses of human beings who lack the means of maintaining a decent or comfortable standard of living.

Another criticism is that under a capitalistic system workers are lacking in economic security. The individual worker is never sure of his job and is at the mercy of the employer. The worker is obliged to look for a job if he is to live, but the owner and employer is under no legal obligation to provide him with a job or to take care of him if he is jobless. The critics claim that this is a serious weakness of the capitalistic system and one that causes social cleavages and antagonisms.

Finally, critics of the capitalistic system claim that the system places too much emphasis on property rights. They claim that capitalism cares more for property rights than for human rights and that, in the eagerness for making profits, human rights are trampled upon and ignored. Critics say that this is demonstrated in the long hours workers must toil to make a living, in bad working conditions, in the manner in which women and children have been exploited, and in the payment of low wages. Although much has been done to remedy these conditions, the criticism still is made.

What Does Socialism Offer?—Several proposals have been made to improve upon capitalism by establishing a new economic system. One of these proposed systems is called *socialism*.

Many definitions of socialism have been given but we shall use the following: Socialism is a system that favors governmental ownership, operation, and distribution of the basic productive resources, and the restriction of private ownership to articles of consumption, homes, farms, and small businesses.

Socialists are split into many groups which do not agree as to how a socialistic state should function. But they all agree that private capitalism should be abolished. Socialists in general favor two principles: (1) They would substitute collective ownership of basic means of production for private ownership. (2) They would have production controlled by some political authority rather than by economic competition. In a socialistic society the only important source of income would be wages, and these would be fixed by central controlling

boards. Socialism is opposed to the private ownership of capital, not to capital itself. Thus, socialists seek to abolish private capitalists who accumulate wealth through collecting interest, rents, and profits.

The program of the socialists is to accomplish their aims through the ballot and thus get control of existing government organizations and use these as instruments for bringing basic industries, transportation services, and other enterprises into public ownership and operation. Thus, socialism would provide for the public ownership and operation of land, forests, mines, factories, banks, railroads, steamship lines, gas and electric-light plants, telegraph and telephone lines, etc. These industries would be operated on the doctrine of "production for use and not for profit." The profits and losses of business under the system of individual initiative would be absorbed by government itself.

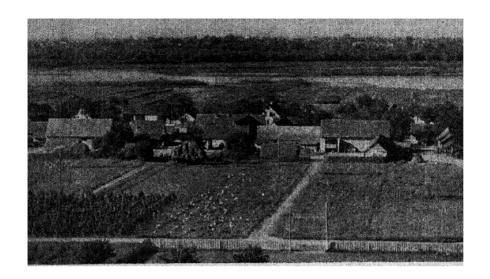
**Socialism Has Its Faults.**—The program of the socialists has been severely criticised. Three of these criticisms are given here.

It Would Hinder Individual Initiative.—It is not natural to expect that men will work hard unless they are sure of gaining something for themselves. With no incentive to work, man would lose his initiative and do no more than he was paid for. The socialist's plan to pay him according to ability and effort would still deprive him of the opportunity to accumulate wealth.

It Would Be Diffcult to Find Efficient Managers for Industries.—Under the socialists' plan, officials of industries would be paid only moderate salaries. It is claimed that this would prevent trained and experienced managers from accepting managerial positions under a socialistic state.

Political Evils Would Flourish in Industry.—Under the capitalistic system it has been difficult to prevent inefficiency, red tape, and graft. The number of employees in government operations is constantly increasing, and it seems almost impossible to reduce their numbers. Critics of the socialistic state claim that when practically everyone in industry is a government employee, these evils will be greatly increased because all industries would be subject to control by politicians.

Has Socialism Accomplished Anything?—As an economic system, socialism has never been practiced in the United States on a large scale. There have been public ownership and operation of local



Sovfoto

A COLLECTIVE FARM IN RUSSIA—This is the collective farm called "Karl Marx" near Stalingrad, Russia. The land is granted (actually rented) to the collective farmer forever by the new constitution.

public utilities and the Federal government has engaged in many lines of production. Some claim that there have been great benefits to the public in these instances, but many disagree with this. However, in some respects socialism has served a useful purpose in showing up some of our weaknesses under capitalism. As a result we have attacked such problems as better housing for low-paid groups, slum clearance, old-age pensions, child labor, unemployment insurance, inheritance taxes, and income taxes.

What Has Communism to Offer?—We have space here to discuss only the economic phase of communism and must leave out the political and social phases. Communism as an economic system would have the ownership and control of all wealth in the hands of government. Thus, under communism there would be no ownership of private property nor would there be any business conducted under private auspices. The government would own everything, and profits would go to the state and not to individuals. Every citizen would work for the government, and there would be no income except wages and salaries and these would not be high. All goods would be owned in common, and each person would produce in accordance with his ability and consume in accordance with his needs. The success of communism depends upon the extent to which men are willing to share everything they have with everybody else.

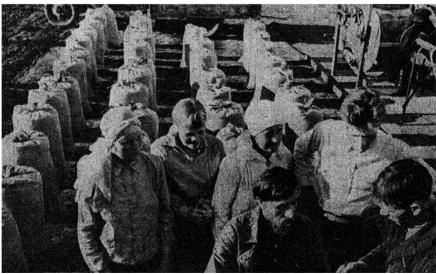


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THE STATE ACT OF PERPETUAL USE OF LAND IN RUSSIA—The representative of one of the large collective farms in Russia is here receiving the State Act for the perpetual use of the land.

PAYDAY ON A COLLECTIVE FARM—This family of a Russian collective farmer is receiving 32,000 kilograms of grain (rye and wheat), which is due them for their year's work. How does this compare with the pay received by the family of an American farmer?

Sovfoto



What has been said above applies to a genuine system of communism. Although this may be what the Russians claim they were aiming at, at the present time these conditions resemble those of socialism more than of communism. A sharp distinction is made between ownership of capital for private gain and ownership of various forms of personal property, such as houses, books, clothes, furniture, for personal use. A Russian is not permitted to accumulate money from his wages, then put this money into a private enterprise, even a small store or shop, and hire people to work for him as an individual. All financial resources in Russia are owned by the state and are invested by the state in various enterprises, such as steel mills, tractor factories, and stores from which people buy goods.

A Russian may use his wages to buy himself a house, and he can buy as much furniture, clothes, books as he can afford or find. The right of inheritance also exists. In theory, at least, the Russian citizen has the right to own personal property, except personal investments, much as one may own private property in other countries.

The Russian laborer does not have the freedom that an American worker has. He has little choice as to where he shall work or what he shall do. He has no opportunity to bargain individually or collectively as to his hours of work or as to a just wage. He is an economic soldier of the state forced to obey without question. Communists claim that their plan assures the individual of greater economic security, does away with unemployment, protects workers in sickness and old age, and assures a living to everyone who is willing to work.

Although communism has some features in common with socialism and each aims to abolish private profit and to serve the public at the lowest possible cost, their methods of gaining their ends are different. Communism believes in force and advocates the overthrow of the existing order. It would completely crush *all* private initiative while socialism would permit some initiative.

**Does Fascism Offer a Satisfactory Program?**—Another rival economic system which has been in the public eye during the past few decades is known as *fascism*. It was developed by Benito Mussolini in Italy and adopted by Hitler in Germany.

Fascism recognizes the principle of private property, but it places many restrictions upon its use. The government subsidizes manufacturers, determines who shall get needed raw materials, and has complete control over wages of workers and prices of goods. Foreign trade is under strict control, and no sales or purchases abroad are possible without a government permit. Profits also are strictly controlled, and interest rates are regulated by government bureaus. The state takes about half of the national income through taxes or forced loans. Business is still largely in private hands, but it is bound up in regulations and restrictions.

Under fascism the worker has few rights as we understand them in our country. The government determines his wages and even goes so far as to tell him where he may or may not work. All labor unions have been abolished, and strikes are prohibited. In the field of agriculture governmental influence has been exerted through organizations to regulate production, processing, sales, and prices. The government also restricts the inheritance of farm land and tells farmers what workers they shall employ.

Fascism is strongly nationalistic and people are regimented in all their activities. The state is considered supreme and the individual must subordinate himself to it.

COMPARISON OF RIVAL ECONOMIC SYSTEMS

	Capitalism	Socialism	Communism	Fascism
Government,	Servant of people. Aids business and individuals	Controls most activi- ties	Supreme. Dictates laws and regulates	
Individuals		Activities restricted	Servants of the state. Have little freedom	Servants of state. Have little freedom
Workers	Free. Can bargain collectively and form unions		Economic slaves. No freedom. No unions	Completely con- trolled by the state
Industries	Privately owned for most part. Some regulations	Collective ownership of basic industries	All owned and man- aged by the state	Restricted by regula- tions. Subsidized by government
Private property	Ownership encouraged. Rights pro- tected	Restricted to personal property	Only ownership of personal belongings allowed	Much restricted
Private profits	Encouraged	Opposed to private capitalism	Practically none	Strictly controlled

Summary.—In the United States we have been living under an economic system which is called capitalism. This is a system in which industry is organized and operated for profit by private enterprise. It is based upon certain principles that permit much individual freedom and initiative. It also permits the accumulation of private property and rewards successful enterprise with profits. Under capitalism there is some government regulation, but this is not usually

so strict as to destroy business initiative or individual ambition. The great prosperity of our country and the high standard of living of our people have been attributed to capitalism.

But capitalism has come in for much criticism. It is claimed to be wasteful of resources and man power; it is said to lack plan. Because of the shortcomings attributed to capitalism, several other economic systems have been suggested as offering a better way of life. Three such systems have gained prominence: socialism, communism, and fascism.

Socialism favors governmental ownership and operation of all productive enterprises and the restriction of private ownership to articles of consumption. Critics claim that under socialism individual initiative would be hindered, efficient managers would be difficult to find, and politics would flourish in industry.

Communism would abolish some private property and would allow few businesses to be conducted by individuals. Government would own all resources. Each person would produce in accordance with his ability and consume according to his needs. Individual initiative would be destroyed to a large extent, and everyone would be strictly regimented. The worker would have no choice as to where he should work or as to what occupation he should follow. He would be an economic soldier of the state, compelled to obey it without question.

Fascism is a system that recognizes the principle of private property but severely restricts it. Profits, wages, interest rates, and prices are all controlled and determined by the government, which is a dictatorship. Under both communism and fascism the individual counts for very little as the state is supreme and everyone owes rigid obedience to its decrees. Business owners and laborers are regimented and can exercise little if any initiative of their own. Those who favor these systems claim that even though laborers suffer the loss of some liberties, they gain in economic security.

#### Questions to Test Your Knowledge

- 1. How do you define capitalism?
- 2. Upon what principles is capitalism based?
- 3. What has capitalism accomplished?
- 4. What are some of the criticisms made of capitalism?
- 5. Define socialism.

- 6. State the two leading principles of socialism.
- 7. What criticisms of socialism have been made?
- 8. What purpose has socialism served?
- 9. Define communism.
- 10. How does communism differ from socialism?
- 11. What is the program of fascism?
- 12. How does fascism differ from communism and capitalism?

#### Questions for Discussion and Application

- 1. What do you understand by the laissez-faire policy? To what extent does this policy operate today?
- 2. It is claimed that there are too many laws that restrict business and individual initiative. Name a few such laws. Are the restrictions just to individuals, to businessmen, and to society? Discuss.
- 3. Which of the four economic systems described in the text do you think offers the most for the greatest number? Give your reasons.
- 4. What do you consider the most fundamental defect in capitalism? How would socialism remedy this? Would communism offer a solution? Would fascism offer a satisfactory solution?
- 5. Discuss the economic program of the communists. How much of this program could be accomplished if regimentation and force were not in effect?
- 6. It is claimed that no economic system can work completely unless there is dictatorial pressure applied from above. Do you agree that this is so? If it is, how can capitalism survive?
- 7. Outline a program whereby the good things of capitalism might be kept while the best in the other programs might be added. To have such a program function, would regimentation be necessary?

#### Floor Talks and Written Reports

- 1. The need for economic reform.
- 2. Socialistic tendencies in the United States.
- 3. Fascistic tendencies during the Second World War.

#### Topic for Debate

RESOLVED, That a modified capitalism is preferable to socialism as a program for social betterment.

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## Chapter XXXVI

# War Economics and Reconversion

#### Aims of This Chapter:

To review some of the changes caused by war.

To sense the problems of reconversion to peace.

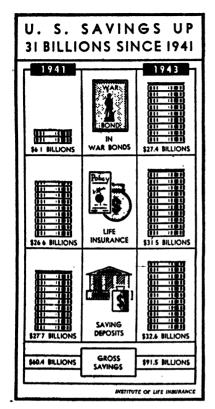
To examine the Reconversion Act of 1944.

To point out the dangers in possible inflation.

The main body of this text has presented the elementary principles of economics as they operate in ordinary times. As the occasion required, you have been informed of some of the changes brought about by the Second World War. Now we shall supplement the text by a chapter which will endeavor to point out to you the problems that arose as we changed over from a war economy to a peacetime economy.

**Economics of Wartime.**—The Second World War was called a "total" war because everybody, whether in the armed forces or not, was very closely affected by it and had a part in it. Of course the most important part was played by the national government. That is, we were made conscious of government through the measures it took to win the war abroad and to preserve our own economic order at home.

During the war the government was obliged to make changes so drastic that they affected the economic life of every person. Millions of men and women of all ages were taken from their regular peacetime occupations and from their homes. They were placed in war industries making all kinds of armaments and ammunition. Millions more were taken into the armed services. The government directed business in a manner entirely unknown before in our country. The war emergency dictated many phases of our daily activities. Government stopped the production of some commodities not directly needed for the war effort. It aided in converting existing industries to war efforts and constructed many new plants. It rationed consumer goods



to civilians here at home, as well as to the armed forces; it directed the flow of war materials to our own troops and to those of the allies. The government recruited, trained, and assigned workers. It regulated most prices. The direction of industry centered in the War Production Board. Many business executives were taken from their regular jobs and brought into government service to assist this board and other government agencies affecting business.

Millions of war workers received higher money earnings than most of them had ever received before. Jobs were available for everyone who was capable of working at all. The wages received by these people added up to an amount of spending power larger than had ever existed. But, whereas more money was available for spending, fewer goods could

be had for the money. This was due to the fact that the production of many articles demanded by consumers in peacetime was sharply restricted or entirely prohibited. Such articles as radios, refrigerators, automobiles, washing machines, and stoves did not exist in sufficient quantities to satisfy the demand for them. If the workers were permitted to spend their money for the scarce articles that were obtainable, prices would soar to fabulous heights and thousands would be unable to obtain any goods at all.

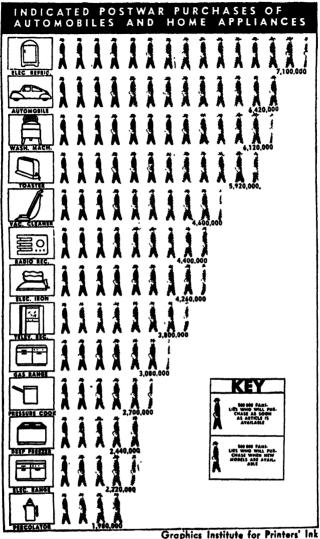
Sensing this danger, the government set up a program which consisted of the following: (1) Price ceilings were established for thousands of scarce commodities as well as rents on private homes and apartments. (2) The wages of most workers were frozen at a figure equal to those on January 1, 1941. The War Labor Board was allowed to grant wage increases only to those who presented proof that their earnings did not permit them to maintain a decent living standard. (3) Scarce and essential articles such as sugar, shoes, butter, meat, canned goods, gasoline, and fuel oil, were rationed. (4) Higher

income taxes were levied to take money from those in the higher income brackets. (5) The number of persons required to pay income taxes was increased through the lowering of exemptions. (5) Consumer credit was restricted by regulations governing charge accounts and installment buying. (7) Everyone was urged to purchase war bonds from current earnings and not from past savings. All these measures were undertaken to hold down prices and prevent inflation.

Problems of Reconversion to Peace.—The conditions outlined above remained in effect throughout the war. But with the end of the war, many serious problems arose. Among the more important of these were the following: (1) How and when should industries be turned back from making war materials to the manufacture of civilian goods? (2) Could the transition be made without causing a serious unemployment problem? (3) How could the armed forces be demobilized with the least disturbance to our economic and social life? (4) What should be done about the termination of war contracts? (5) Should price controls be maintained after the war, or should they be terminated at once? (6) How was serious inflation to be avoided if workers started to spend the billions they had saved? (7) How much government regulation of business and individuals should be kept?

There were many other problems, and each of the above problems involved others. To thinking men it was evident that something should be done about them before the war ended so that we might not be found unprepared for peace and have to face a breakdown in our economic order. Naturally, this caused much discussion, and many views were expressed as to the best way to handle these problems. Congress finally took action, and in October, 1944, the President signed the Reconversion Act. This was not entirely satisfactory to everyone, but it was a step toward getting back to peacetime conditions.

How Should Reconversion be Handled?—This law created a new agency, the Office of War Mobilization and Reconversion, to absorb several agencies that had been functioning during the war. The law laid down rules for the demobilization of the Army and the Navy. Those services were directed not to retain any person for the purpose of preventing unemployment or to await opportunity for re-employment. War contracts were to be terminated when there was no military need that justified their fulfillment. The director of the office was to be the over-all policy maker. He should issue orders and



regulations to executive agencies. He could decide when emergency war controls should be relaxed or removed altogether; when wartime agencies should be curtailed, consolidated, or eliminated. He was also to act as arbiter in settling disputes among executive agencies. He was to be assisted by an advisory board, but he did not have to abide by the advice of the board.

Thus businessmen everywhere were affected by the decisions of the director on matters involving control of materials, restrictions on civilian production, prices, rationing, etc. Employers as well as employees were concerned by decisions about wages, working hours, man-power control, etc.

Could We Maintain Our National Income?—The Second World War not only changed the character of our national income but also increased its size. Our industries changed over from the production of consumer goods, such as pleasure automobiles, radios, and electric refrigerators, to the production of war materials, such as tanks, airplanes, jeeps, and trucks. When peace came, it was necessary to change back again to the usual channels of trade and to the production of those economic goods which we had gone without and for which there was a large, pent-up, unsatisfied demand.

Not only was the character of goods produced during the war different, but the quantity of goods produced was greater than ever before in our history. Huge sums were paid for these goods, and the national income grew by leaps and bounds. The previous peak of national income was reached in 1929, when it was about 90 billion dollars. At the bottom of the depression in 1932–1933, the national income fell to about 45 billion dollars. From this point it gradually rose but did not reach the peak of 1929 until the outbreak of the Second World War. The beginnings of hostilities in Europe changed the United States into a vast arsenal and greatly expanded our national income. Within the short space of four years, the national income of the United States almost doubled, increasing from about 100 billions in 1939 to almost 200 billions in 1943. Much of this unprecedented increase in our national income came from war goods, most of which were sold abroad and thus not consumed at home. The end of hostilities brought the possibility of a reduction in the size of our national income, swollen by the war. If this reduction were sudden and sharp, our economic life would be seriously affected. Thus it became a challenging problem how to maintain the size of our national income and at the same time change its form and improve its quality.

Could Full Employment Be Assured?—Closely related to the problem of maintaining the national income at wartime level was the problem of keeping employment somewhere near the level of the war years. During the depression that followed 1929, the number employed decreased as production decreased and national income declined. In the chapter on the business cycle (Chapter XXXII), it

was pointed out that the government engaged in various relief projects and programs of public work. During the Second World War, this situation was reversed; the main economic problem became one of a critical man-power shortage instead of serious unemployment. Women left their homes and young people left high school to take up work in factories, shipyards, and offices.

Changing from peacetime production to war production meant a big shift of population to the centers of production. Likewise, a change from war production back to peacetime production involved the reverse change of population. But there was the prospect of reduced, rather than increased, employment. The change-over from one type of work to another may have meant temporary unemployment for many. An even more serious prospect was that the total volume of production and employment might fall to a permanently lower level. Inventions and improvements have made industry more efficient and enabled factories and farms to produce more goods in less time with fewer workers. If private enterprise became unable to provide jobs for all those who were able and willing to work, the government might be forced to take over by providing relief projects on public works as it did during the great depression. Thus we were faced with the major problem of formulating plans to provide work for those who were engaged in war industries and now sought work in peaceful occupations.

Danger of Inflation.—A very serious problem of reconversion was how to prevent too sharp a swing toward inflation or deflation. Everyone was agreed that abrupt change in the general price level must be avoided and that the transition must be under control at all times. But there seemed to be no agreement as to how it should be controlled. Many felt that government controls should be continued for some time; while others believed that it would be better to have all controls cease.

Briefly the problem boiled down to this: The American people had saved the total sum of about 120 billion dollars during the years beginning with 1940. Of this sum about 28 billion dollars had gone into insurance, reduction of debts, and home development. The remaining 92 billion dollars was in bank deposits, currency, and investments, chiefly government bonds. If the people as a whole spent this sum at once, it would bring on a very serious inflation. But it turned out that there were not enough goods in existence to meet the demand that had been accumulating during the war. Without some

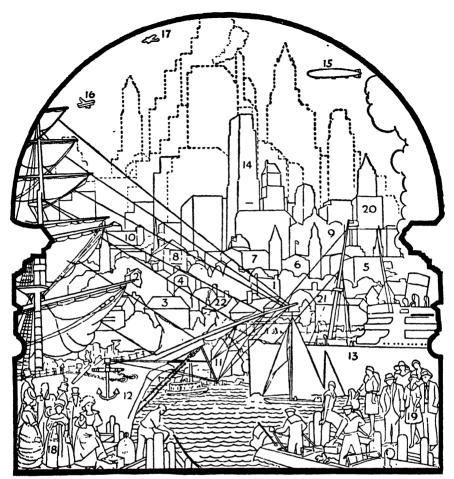
sort of control over prices and production, consumer prices would rise so high that millions who had only a small income would suffer great hardships.

In order to hold prices down and prevent the evils of inflation, the Office of Price Administration (OPA) placed a ceiling on thousands of articles of common use, and merchants were forbidden to charge more than the price set. Rents were also fixed, and wages were frozen in most cases. Billions of dollars were paid to farmers in the form of subsidies to prevent a rise in the prices of grain, butter, cheese, and other dairy products.

In spite of all efforts to hold prices in line and to keep wages from rising, the end of the war saw many strikes which resulted in a great increase in the wages of thousands of workers. Producers insisted that they must be allowed to raise prices in order to pay these higher wages. The OPA did allow many increases, and many ceilings were raised. The black market flourished in meats, dairy products, and other fields. The situation became serious as the date for the expiration of OPA approached. Dissatisfaction with price control, as administered, led Congress to pass a bill to continue OPA, but since President Truman believed that amendments to the new bill would have brought serious inflation, he vetoed the bill.

This created a confused state with no governmental control. Meanwhile, some merchants took advantage of the lifting of ceilings to increase prices; others tried to keep the same prices as were allowed under OPA; some lowered prices. Some hoped that no new bill would be passed but that after a few hectic months without price controls the laws of demand and supply would operate to stabilize prices.

In August, 1946, Congress finally passed a makeshift bill which was signed reluctantly by the President. This new bill took away from the OPA much of its former authority to control prices and set over it a Decontrol Board which had power to overrule the OPA and to set new prices for many of the goods that consumers use. Moreover, the Secretary of Agriculture was given authority to set prices. This meant that there were three agencies which had the task of regulating prices and establishing ceilings. While the new bill caused much confusion and led again to a scarcity of goods, it was hoped that it would do away with black markets—in foods, at least. This bill extended the life of the OPA for one year, with the understanding that controls were to be relaxed as fast as seemed just and reasonable.



Courtesy of Brooklyn Savings Bank

Key to illustration opposite page 131

- 1. Residence of Adrian Van Sinderen
- 2. Apprentices' Library Association Building
- 3. Residence of Hezekiah Pierrepont
- 4. Henry Ward Beecher's Church
- 5. Underbill's Colonnade
- 6. City Hall
- 7. Old Court House
- 8. Brooklyn Savings Bank Building, Clinton and Pierrepont Streets
- 9. New Municipal Building
- 10. Leverich Towers Hotel
- 11. Old Fulton Ferry House
- 12. Ship Great Republic

- 13. S. S. Aquitania
- 14. Montague-Court Building
- 15. Dirigible "Los Angeles"
- 16. Mail Plane
- 17. Hydroplane
- 18. Group of Brooklynites, Costume of 1827
- 19. Group of Brooklynites, Costume of Today
- 20. Williamsburgh Savings Bank Building
- 21. Residence of Miss Rappelyea
- 22. Residence of Mr. Burrows (Harness Maker)

# **Bibliography**

For the convenience of teachers and those ambitious students who wish to learn more about the subjects studied in this textbook, the books and pamphlets listed at the ends of the chapters are given here with name of publisher and date of copyright. They are listed here in two sections. Section I contains advanced texts that are general in nature. Section II contains books and other references that treat of single topics or a few topics.

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### Selected List of Motion Pictures

The following list of selected motion pictures can be used to supplement much of the text material in this book. After each title is a brief description of the film or the purpose for which it can be used. However, many of the films can be used several times for different purposes. For example, some of the films demonstrating manufacturing processes can be used to show various occupations; some of the films dealing with conservation can be used to demonstrate agricultural methods, mining methods, or lumbering methods, etc.

These films can be borrowed or rented from the producers or distributors listed after the title, or, in many cases, they can be secured from your local film library or film distributor. The running time (min.) and whether it is silent (si.) or sound (sd.) are also given for each film. See end of listing for addresses of producers and distributors.

- Strength Unseen (Y.M.C.A., 20 min., sd.). The story of how America has outproduced other nations.
- The Making and Shaping of Steel (U.S. Bur. Mines, 70 min., si.). A series of seven reels, progressing from the processing of raw materials to the making of steel and the production of various steel products.
- Steel—Man's Servant (U.S. Steel, 38 min., sd.). The story of the making of steel.
- Alloy Steels—A Story of Their Development (U.S. Bur. Mines, 20 min., sd.). Traces the development of alloy steels and indicates the relationship between new tools and industrial progress.
- Tin (Eastman, 15 min., si.). Shows the mining of tin ore, the manufacturing of tin, and a few of the important uses of tin in industry.
- Science Rules the Rouge (Ford, 21 min., sd.). Shows the relationship between science and modern industry and contrasts handicraft methods with modern industrial production.
- From Mine to Consumer—The Story of Anaconda (Am. Brass, 30 min., si.). Shows the mining and purifying of copper, the manufacturing of copper alloys, and the modern methods of rolling and shaping copper alloys.

- Wildwood: One Hundred Per Cent Mechanized Mine (U.S. Bur. Mines, 45 min., si.). Shows the operation of a mechanized mine and the use of modern machinery in the coal industry.
- The Story of Gasoline (U.S. Bur. Mines, 30 min., si.). Can be used to show the importance of science in modern industry and the complexity of a large industrial organization.
- Evolution of the Oil Industry (U.S. Bur. Mines, 60 min., si.). Traces the development of the oil industry and shows the processes of drilling, pumping, refining, transporting, and testing of oil.
- Men and Oil (Films, Inc., 20 min., sd.). Will be useful in developing an understanding of the struggle of different interests for the control of new industries and in contrasting the business ethics of an earlier period with those of today.
- The Story of Asbestos (U.S. Bur. Mines, 30 min., si.). Shows the sources, refining processes, and uses of asbestos in modern industry.
- Science and Agriculture—The Soy Bean (E.B.F., 11 min., sd.). Shows the procedure for producing and processing soy beans and the interdependence of agriculture and industry.
- Sugar: Rebuilding an Island Industry (U.S. Interior, 20 min., sd.). Briefly shows planting, harvesting, and refining of sugar cane.
- Nickel (U.S. Bur. Mines, 30 min., si.). Will be useful as a basis for discussing modern industry and the importance of natural resources.
- Meat Packing (Eastman, 15 min., si.). Shows meat processing in a packing house and the work of the government in protecting health through meat inspection.
- Heritage We Guard (Soil Cons., 30 min., sd.). Shows the value of protecting wild life in connection with soil conservation.
- The Work of the Atmosphere (E.B.F., 11 min., sd.). Useful in developing an understanding of relationship of the atmosphere to soil conservation.
- The River (U.S. Agric., 31 min., sd.). Useful in developing an understanding and appreciation of the harm that can result from the destruction of any of our natural resources and of what flood control can accomplish.
- The Work of Rivers (E.B.F., 10 min., sd.). Useful for a discussion of flood control as a means for conserving natural resources.

- Empire of the West (B.&H., 30 min., sd.). Shows the necessity for long-term planning and cooperation between local and national governments for the conservation of natural resources.
- City Water Supply (E.B.F., 11 min., sd.). Shows the importance of a water-supply system as a public service and demonstrates procedures used in safeguarding it.
- Flood Weather (U.S. Agric., 30 min., sd.). Shows the importance of the United States Weather Bureau for reporting impending flood conditions.
- Prices of Progress (U.S. Interior, 20 min., sd.). Shows some of the conservation activities conducted by the United States Department of Interior and the need for additional conservation practices.
- Conservation of Natural Resources (E.B.F., 11 min., sd.). Discusses methods used to conserve natural resources.
- The Plow That Broke the Plains (U.S. Agric., 27 min., sd.). Shows the conditions of the Great Plains before the plowing of the original grass sod, how the Plains developed into the dust bowl, and how the settlers became migrants.
- Irrigation Farming (E.B.F., 11 min., sd.). Shows the need for irrigation projects in the United States, their value, and their extent.
- Reclamation of the Arid West (U.S. Interior, 11 min., sd.). Shows the value of irrigation in making dry lands productive.
- Trees to Tame the Wind (U.S. Agric., 12 min., sd.). Shows procedure for establishing rows of trees for shelter and the use and value of these shelters to agriculture.
- The Tree of Life (U.S. Agric., 19 min., sd.). Traces the government's conservation policy in developing national forests and shows the procedure followed for scientific lumbering.
- Trees and Men (Weyerhaeuser, 40 min., sd.). Shows logging and milling operations and the development of the forest conservation program.
- Pine Ways to Profit (U.S. Agric., 20 min., sd.). Shows the value of timber as a crop. Shows damages caused by forest fires and suggests methods to prevent fires.
- Harvesting the Western Pines (Western Pine Assn., 30 min., sd.). Shows some of the techniques and procedures used in pine lumbering and milling and some conservation practices.
- Let's Go American—Men and Machines (N.A.M., 10 min., si.-sd.). Shows how the development of the machine has created many new jobs.

- Men and Ships (U.S. Maritime Comm., 25 min., sd.). Shows the training of men for the Merchant Marine; useful in developing an understanding of the vocational opportunities in the Merchant Marine.
- Men of Medicine (March of Time, 16 min., sd.). Useful for showing the training necessary to become a doctor.
- The Machine Maker (E.B.F., 11 min., sd.). Useful for showing the skills needed in the machine tool industry.
- The Builders (E.B.F., 20 min., sd.). Useful in developing an appreciation of the skills required in the building trade. Shows the extent of interdependence among the various building and construction trades.
- Making a V-type Engine (U.S. Bur. Mines, 30 min., si.). Illustrates some of the techniques in modern mass production on an assembly line.
- Chemistry in a Changing World (E.B.F., 11 min., sd.). Shows the importance of chemistry and the work of the chemist in the modern world.
- Here Is Tomorrow (Coop. League, 35 min., sd.). Shows the accomplishments and scope of the cooperatives throughout the country.
- Co-ops Are Comin' (Coop. League, 35 min., si.). Shows the operation of the various consumer cooperatives in the Middle West and South.
- Interdependence (Harvard, 30 min., si.). Illustrates the interdependence of individuals, communities, and nations.
- Toward Unity (BraF, 11 min., sd.). Shows that all men regardless of race, color, or creed have mutual needs, emotions, thoughts, and problems.
- The World We Want to Live in (Nat'l Con. of Christians & Jews, 11 min., sd.). Can be used to show the social and political conditions that contribute to the development of racial and religious intolerance.
- World of Plenty (BraF, 45 min., sd.). Deals with the distribution, production, and consumption of food, and its importance in present and postwar problems.
- **Protecting the Consumer** (March of Time, 7 min., sd.). Useful as a basis for discussing business ethics and the extent of government responsibility to protect the consumer.

- Getting Your Money's Worth (Pictorial, 10 min., sd.). Useful for developing a critical attitude when purchasing various commodities.
- The Mint (T.F.C., 10 min., sd.). A complete description of the processes of coining money.
- Making Money (U.S. Sec. Serv., 30 min., sd.). Shows the operation of the Bureau of Printing and Engraving in the production of paper currency.
- Know Your Money (U.S. Sec. Serv., 20 min., sd.), Dangerous Dollars (T.F.C., 11 min., sd.), Doubtful Dollars (U.S. Sec. Serv., 17 min., sd.). Show how to recognize the difference between real and counterfeit money.
- Check and Double Check (U.S. Sec. Serv., 17 min., sd.). Deals with the methods used by check thieves and forgers in stealing and cashing government checks.
- **Sign of Dependable Credit** (Castle, 20 min., sd.). Shows the organization and operation of a credit association and how the farmers use it to buy equipment.
- Money to Loan (T.F.C., 22 min., sd.). This picture deals with the operation of unscrupulous small loan companies.
- Your Dollars in Uniform (Sav. Bank, 19 min., sd.). Traces development of savings banks and importance of savings accounts.
- **People's Bank** (CFB, 20 min., sd.). A description of the growth of the credit unions in various fishing, mining, farming, and industrial communities.
- Yours Truly, Ed Graham (Inst. Life Ins., 23 min., sd.). Good for explaining life insurance and how it can be made to fit the different needs of many people.
- American Portrait (Inst. Life Ins., 26 min., sd.). Demonstrates the place of life insurance salesmen in the community; it shows that they are as essential as the doctor, the lawyer, and other professional people.
- Fight for Honest Ballots (B.&H., 40 min., sd.). Shows how citizens can ensure clean elections by voting and through watchful enforcement of existing election laws.
- **Development of Transportation** (E.B.F., 10 min., sd.). Useful in understanding the effect of rapid transportation on our social and economic life.
- Land Transportation (Harvard, 15 min., si.). Deals with the history of land transportation and demonstrates how the

- earth shrinks in size as different forms of transportation develop.
- Arteries of the City (E.B.F., 11 min., sd.). Shows the elements that affect the development of a city's transportation facilities.
- Coast to Coast by Plane (U.A.L., 30 min., si.). Useful in showing the vocational opportunities in aviation and the place of aviation in transportation.
- Air Waves (Ganz, 10 min., sd.). Useful as the basis for a discussion of radio influences on everyday life.
- A Hurricane's Challenge! (A.T.&T. 15 min., sd.). Useful in giving an understanding of the importance of communication, especially during periods of disaster.
- Work of the Stock Exchange (Coronet, 15 min., sd.). Useful for explaining the buying and selling of securities, stock exchanges, and the part that they play in our economic system.
- United States Treasury (T.F.C., 10 min., sd.). A description of the various departments in the United States Treasury.
- Man Power (OWI, 8 min., sd.). Shows the setup and operation of the War Manpower Commission for supplying skilled workers to industry.
- Work Pays America (WPA, 37 min., sd.). Shows a government program of social and economic rehabilitation.
- **Social Security** (T.F.C., 10 min., sd.). Useful for discussing the operation of the Social Security Act.
- Social Security Benefits (Soc. Sec. Bd., 18 min., sd.). Useful as the basis for the study of the responsibility of government in providing for the care of the aged.
- Old Age and Family Security (Soc. Sec. Bd., 10 min., sd.). A description of the operation of the Federal Old Age and Survivors Insurance.
- Soak the Old (T.F.C., 21 min., sd.). Useful for showing methods used by racketeers to exploit the old-age pension movements.
- **Problem of Relief** (March of Time, 6 min., sd.). Shows the necessity for a democratic approach to the problem of relief.
- Growth of Cities (E.B.F., 10 min., sd.). Shows the factors which determine the location and growth of cities and the necessity for proper city planning.
- **Shelter** (E.B.F., 11 min., sd.). Shows different types of housing and the materials and skills necessary for constructing modern buildings.

- **Housing in Our Times** (Fed. Housing, 21 min., sd.). Useful as the basis for a study of the extent of public responsibility for good housing.
- A Place to Live (BraF, 18 min., sd.). Shows the home life of a family in substandard housing.
- The City (BraF, 30 min., sd.). Deals with the problem of city planning and the trend toward decentralization.
- Homes for Defense (BraF, 10 min., sd.). Shows various types of housing being provided for war workers by government agencies.
- Housing in America (E.B.F., 11 min., sd.). Contrasts the "dream" home of modern technology with the inadequate houses of today.
- Today We Build (Fed. Housing, 30 min., sd.). Contrasts well-planned versus poorly planned housing and shows some of the developments of housing in foreign countries before the war.
- The Sharecroppers (March of Time, 8 min., sd.). Useful in showing the urgency and importance of the economic problem in the South.
- Yankee Doodle Goes to Town (T.F.C., 11 min., sd.). Useful in showing the influence of the press on public opinion and of advertising on the standard of living.
- **Arm Behind the Army** (OWI, 10 min., sd.). Shows the need for unity between management and labor and between civilian war workers and the armed forces.
- Valley Town (N.Y.U., 27 min., sd.). Shows the necessity for continued training in order to keep abreast of new developments and to prepare for new and better jobs.
- Machine—Master or Slave (N.Y.U., 14 min., sd.). Shows the problem that management faces in dealing with the economic and financial factors involved in technological progress.
- Man: His Job (BraF, 18 min., sd.). Traces the problems of unemployment and shows the rise and function of unemployment insurance.
- Labor Front (BraF, 21 min., sd.). Shows the contribution to the war effort of labor and management in the United States as contrasted with the handling of Axis man power.
- Partners in Production (BraF, 21 min., sd.). Reviews the different kinds of labor-management committees in England and the methods that they used to ensure cooperation for production.

- Welfare of the Workers (BIS, 9 min., sd.). Shows the benefits that the trade unions have secured for the British workingman.
- Amer. Brass—American Brass Company, General Sales Department, Waterbury, Conn.
- A.T.&T.—American Telephone and Telegraph Company, Information Department, 195 Broadway, New York, N.Y.
- B.&H.—Bell & Howell Company, 30 Rockefeller Plaza, New York, N.Y.
- BIS—British Information Services, 30 Rockefeller Plaza, New York 20, N.Y.
- BraF-Brandon Films, Inc., 1600 Broadway, New York 19, N.Y.
- CFB—National Film Board of Canada, 84 East Randolph St., Chicago, Ill.
- Castle—Castle Films, Inc., RCA Building, Rockefeller Center, New York 20, N.Y.
- Cooperative League, 167 West 12th Street, New York, N.Y.
- Coronet—Coronet Productions, Glenview, Ill.
- Eastman—Eastman Kodak Company, Teaching Films Division, Rochester, N.Y.
- E.B.F.—Encyclopaedia Britannica Films, Inc., 1841 Broadway, New York, N.Y.
- Fed. Housing—Federal Housing Administration, Radio and Motion Picture Section, Washington, D.C.
- Films, Inc., 330 West 42d Street, New York 18, N.Y.
- Ford—Ford Motor Company, Department of Photography, 3674 Schaefer Rd., Dearborn, Mich.
- Ganz-Wm. J. Ganz Company, 19 East 47th Street, New York, N.Y.
- Harvard—Harvard Film Service, School of Education, Lawrence Hall #4, Cambridge 38, Mass.
- Inst. Life Ins.—Institute of Life Insurance, 60 East 42d Street, New York, N.Y.
- March of Time, 369 Lexington Avenue, New York, N.Y.
- N.A.M.—National Association of Manufacturers, 14 West 49th Street, New York 20, N.Y.
- National Conference of Christians and Jews, 381 Fourth Avenue, New York 16, N.Y.
- N.Y.U.—New York University, Film Library, Washington Square, New York 12, N.Y.

- OWI—Office of War Information, Bureau of Motion Pictures, Washington, D.C.
- Pictorial—Pictorial Film Library, Inc., RKO Building, Radio City, New York 20, N.Y.
- Sav. Bank—Savings Bank Association of New York State, Movie Division, 110 E. 42d St., New York, N.Y.
- Soc. Sec. Bd.—Social Security Board, 11 West 42d Street, New York, N.Y.
- Soil Cons.—Soil Conservation Service, Upper Darby, Pa.
- T.F.C.—Teaching Film Custodians, Inc., 25 West 43d St., New York 18, N.Y.
- U.A.L.—United Air Lines Transport Corp., 5955 South Cicero St., Chicago, Ill.
- U.S. Agric.—United States Department of Agriculture, Division of Motion Pictures, Washington, D.C.
- U.S. Bur. Mines—United States Bureau of Mines, Experimental Station, 3800 Forbes St., Pittsburgh, Pa.
- U.S. Interior—United States Department of the Interior, Division of Information, Photo Section, Washington, D.C.
- U.S. Maritime Comm.—United States Maritime Commission, Division of Information, Washington, D.C.
- U.S. Sec. Serv.—United States Secret Service, Treasury Building,Washington, D.C.
- U.S. Steel—United States Steel Corporation, Advertising Dept., 436 Seventh Avenue, Pittsburgh, Pa.
- WPA—Work Projects Administration, Division of Motion Pictures, Washington, D.C.
- Western Pine Association, Yeon Building, Portland, Ore.
- Weyerhaeuser Sales Company, First National Bank Bldg., St. Paul, Minn.
- Y.M.C.A., Motion Picture Bureau, 347 Madison Avenue, New York, N.Y.

## Glossary

This glossary contains brief definitions and explanations of many of the terms and expressions which the pupil uses or sees almost daily but does not always understand. Some of the terms explained here are found in the text, but several of them are not found in the text. By consulting this glossary the pupil will get needed information about terms he meets in his study of economics.

- **AAA** (Agricultural Adjustment Administration). One of the agencies of the New Deal which aids farmers and agriculture in general by raising farm prices, controlling production, insuring crops, and restoring purchasing power.
- Alloy. The name given to the mixture of harder metals used in coining gold and silver in order to make them last longer.
- **Apprentice.** One who is bound by a contract to work for another person or firm in order to learn a trade.
- **Arbitration.** A method of settling labor disputes whereby the dispute is submitted to an outside individual or board for settlement. Arbitration may be compulsory or voluntary.
- Assessed valuation. The value set upon property for the purpose of taxation. It is usually not the real value but one-half or two-thirds.
- Balance of trade. A term used in foreign trade to indicate the difference of value between imports and exports. When the exports exceed the imports in value, the balance is said to be favorable; when the imports exceed the exports in value, the balance is said to be unfavorable.
- Bank note. A written promise of a bank to pay a specified sum of money to the bearer on demand. Bank notes are put into circulation by being paid out by the bank to customers. They circulate from hand to hand without endorsement, as other money circulates.
- Bankruptcy. The state of being legally declared unable to pay one's debts. Bimetallism. A monetary system in which two metals, usually gold and silver, serve as standard monies, with free coinage of each metal at a fixed ratio and full legal tender power given to both.
- Black list. The employer's list of those workers who are considered agitators or troublemakers or who are known to be members of labor unions. When such workers seek employment elsewhere, their names and records are passed on to other employers, and they find it difficult to obtain employment.

- **Bonus.** As used in economics, this term applies to any extra pay given to workers for increasing their output or as a share in the profits of the company.
- **Boycott.** A method used by labor organizations which aims to prevent anyone from dealing with a firm against which they are striking. Named after Captain Boycott against whom it was first used in 1880.
- **Budget.** An estimate of income and a plan of expenditures for a certain period of time.
- **Bullion.** Bars of metal, either pure or mixed with alloy. These bars may be shipped instead of money or sent to the mints to be made into coin.
- **Business cycle.** Changes that take place in business conditions over a period of time.
- **Capitalism.** An economic system based upon private ownership of property, individual initiative, competition, and the right to earn profits. It is the system that prevails in the United States.
- Capitalistic production. Production by the use of vast amounts of capital, large numbers of workers, many modern machines, and standardized products. Sometimes called "big business."
- **Capitalization.** The total amount of money represented by the outstanding stocks and bonds of a corporation.
- **Charter.** A document granting special rights and privileges to a corporation in the conduct of a certain business. Charters are granted by the Federal government and the several states.
- **Checkoff.** A plan by which employers deduct union dues from a worker's wages and pay them over to the union.
- CIO (Congress of Industrial Organizations). A national labor organization formed in 1935 as a rival to the American Federation of Labor. It advocates the organization of workers in mass-production industries by whole industries rather than by trades or crafts.
- Closed shop. A shop in which only certain types of workers may be employed. Sometimes only union men are employed; sometimes only nonunion men are employed; at times anyone may be employed, provided he agrees to join the union as soon as he begins work.
- Closed union. A union that seeks to limit its membership by making entrance conditions difficult. This may be done by charging high initiation fees, by making dues high, or sometimes by requiring the passing of rigid tests.
- Collective bargaining. The method by which employees as a group bargain with employers through a committee of their own choosing. The committee represents the majority of the workers.
- Collectivistic. Tending to be under the control or ownership of organized society, especially of its political governments.

- Combination. The merging of several companies or corporations into one large corporation. A combination may be of horizontal or vertical type. Its purpose is to eliminate competition and to control prices.
- Commercial paper. A term used to designate promissory notes of business firms, trade acceptances, bills of exchange, and anything else that banks will accept as a basis for lending money.
- Commercial rent. Payment made for the use of a house, a store, land, a typewriter, etc. It is a payment for the temporary use of durable goods which are to be returned to the owner at some future time—sometimes called contract rent.
- Communism. An economic system which abolishes all private property and limits individual enterprise. All means of production, all capital, and all land belong to everyone in common, but everything is controlled by the government.
- Compensated dollar. A proposed plan to stabilize the value of the dollar. The weight of the dollar would be changed from time to time in order that its purchasing power may remain more stable. It is also called the commodity dollar.
- **Competition.** The rivalry of two or more individuals, firms, or corporations, working independently, to obtain a desired end.
- Concentration of capital. The larger portion of capital goods and capital funds controlled by a relatively few individuals or corporations.
- Conciliation. The method of settling labor disputes by conference between representatives of employers and employees.
- Conservation. A policy designed to build up and preserve our natural resources, such as land, forests, mineral deposits, and oil.
- Contract. An agreement between two or more parties which the law will enforce.
- **Cooling-off period.** A delay imposed upon employees and employers during which there may be no strikes, lockouts, or other stoppage of work.
- Cooperation. The voluntary working together and pooling of resources for the purpose of accomplishing some desired end. Teamwork.
- **Copyright.** The exclusive right granted by the government to multiply for sale copies of literature or art.
- **Corporation.** An association of individuals created by law to conduct a business under a charter granted by the state. The law regards it as an artificial person.
- Creditor. One to whom others owe sums of money.
- **Credit Union.** A cooperative savings and loan association confined to a specific group of people.
- Crisis. A turning point in business. An economic situation full of great danger or difficulty.
- Currency. Anything that passes from hand to hand as a medium of exchange.

- **Debtor.** One who owes money to others.
- **Deflation.** The process of reducing the general price level in terms of money. In a period of deflation, prices are low while purchasing power of the dollar is high.
- **Deposit insurance.** The practice of insuring deposits of individuals and companies in banks against possible loss in case banks fail or close. Insurance applies to deposits of \$5,000 or less.
- Depreciation. A loss in value of property due to use or age.
- **Depression.** Period of a business cycle when things are at their worst. Unemployment is great, wages and prices are low, and business is poor.
- **Devaluation.** As applied to money, it means reducing the gold content of the dollar. When the gold content of the dollar was changed from 23.22 grains of pure gold to 13.71 grains, the dollar was devalued.
- **Discrimination.** A term used to describe the practice once used by railroads and other carriers of favoring certain persons, places, and kinds of goods, by granting them lower rates than others.
- **Dividend.** Share of the profits of a corporation paid to the stockholders, who are the owners. They may be paid in cash or in additional shares of stock.
- **Dumping.** Exportation of goods to foreign countries for the purpose of getting rid of a domestic surplus or of ruining the industries in competing countries. Such goods are sold at a lower price in a foreign country than in home markets.
- **Economic law.** The statement of a tendency of given economic causes to produce certain economic results. Not so precise as a natural law.
- Elastic currency. Currency that can be increased or decreased in quantity as business conditions call for it.
- Enterprise. A business undertaking that is dependent for its success upon the foresight, energy, wisdom, and courage of those who enter upon it.
- Extensive cultivation. The use of small quantities of labor and capital on a relatively large quantity of land.
- Fascism. An economic system which recognizes private initiative and private property but subjects both to the regulation and control of the government. Business is in private hands but subject to the strict supervision of the government.
- Fiat money. Paper money which the government promises to redeem sometime but which is not redeemable in specie. So called because its use as money depends upon the command of the government that issues it. Also called "inconvertible money."
- Fiscal. Pertaining to financial affairs. A fiscal agent is one who takes care of the financial affairs of a person or firm.

- Fluctuation. Act of changing, varying. Applied to rising and falling prices.
- Foreclosure. A legal process whereby one who holds a mortgage may force the mortgagor to redeem or forfeit property pledged if the mortgagor fails to pay interest or principal.
- Franchise. An exclusive right granted by a government to an individual, firm, or corporation to carry on a certain kind of business. Public utilities operate under a franchise.
- Free trade. The conduct of trade among nations and states without the imposition of tariffs of any kind.
- Funding a debt. The fixing of terms under which a debt is to be paid. It generally involves the spreading of repayments over a period of time by converting a short-term or floating loan into a long-term obligation. This is sometimes accomplished by an issue of bonds.
- Greenbacks. The name given to United States notes when they were first issued during the Civil War, because a peculiar green ink was used to print their backs.
- Holding company. A corporation that holds a majority of the stock of individual corporations that join together for united action.
- **Incorporation.** The legal procedure necessary to bring a corporation into existence.
- Increment. That which is gained or added.
- Index number. A mathematical figure used to express the price level, volume of trade, etc., of a given year in comparison with that of another year (assumed to be 100).
- Industrial income. Total income in terms of money received from the sale of the products and services of the country. Sometimes called national income.
- Industrial union. The organization into one union of all the workers of a given industry. The United Mine Workers is an industrial union.
- Inflation. A condition in which prices are high and purchasing power of the dollar is low.
- Injunction. An order issued by a court restraining an individual or individuals from performing a specified act or acts. It is often used by employers to end a labor dispute since it has the effect of stopping picketing and possible damage to property.
- Institution. Anything forming a characteristic and persistent feature in economic or social life and habits. Private property, competition, and freedom of contract are institutions of our economic society.
- Intensive cultivation. The use of large quantities of capital and labor on relatively small quantities of land. Making land have maximum yield.

- Interlocking directorate. A number of separately organized corporations managed by the same, or nearly the same, group of directors. Now illegal where the intent is to form a monopoly.
- Labor turnover. Term used in industry to apply to the necessity of employing new men to take the place of those who are discharged or quit for other reasons. It is expensive to industry in that it causes waste of material by new, untrained workers.
- Laissez faire. A policy that aims to keep business free from interference by government. It is often called a "hands-off" policy.
- Lend-lease. The legal provision under which the United States extended aid of all kinds to its allies in the Second World War.
- Liabilities. Debts or sums of money owed by an individual, firm, or corporation.
- License. A formal permission from the government to perform certain acts or to carry on a certain business which otherwise would be illegal.
- Lien. A legal claim upon property pledged as security for payment of a debt.
- Liquidation. The termination of a business by turning its assets into cash.
- Lobby. To address or solicit members of a legislative body in the lobby or elsewhere with intent to influence their votes by personal agency.
- Marginal land. A term applied to land which, under conditions of the market, barely repays the cost of its cultivation.
- Marginal worker. The last worker whom it pays to employ in a given plant or in the cultivation of a given piece of land.
- Market price. The price at which a commodity or security is being sold in the market at a given time.
- Market ratio. The relation that exists between gold and silver in the open market where they are bought and sold, such as 20 to 1.
- Mediation. A means of settling labor disputes peacefully. An outside party brings together the disputing parties for the personal settlement of the trouble through discussion and agreement, the acceptance of the result being optional.
- Medium of exchange. Any convenient device that enables us to make exchanges of goods and services conveniently. Money serves as this medium. Labor is exchanged for money and money for goods.
- Middleman. Any individual or agency through whose hands goods pass on their way from the producer to the consumer. Also used to designate those who finance operations for others, as banks.
- **Minimum wage.** A legal rate of wages which is the lowest an employer may pay for the services of labor.
- Mint ratio. The relation between the price of gold and silver as set at the United States mints. It is fixed by law and does not change unless changed by law.

- Monetary. Relating to money.
- Monopoly. Exclusive control over the supply of a commodity or service which enables the monopolist to set its price, free from competition.
- Monopoly price. That price which brings the greatest net profits to the monopolist.
- Mortgage. A legal document that conveys title to property as security for the payment of debt or for the performance of an act.
- National income. The total income of the nation as a whole, usually estimated in terms of money. Thus, the national income for 1940 was estimated at about 84 billion dollars.
- Negotiable. Transferable by delivery so that title passes to the person receiving the item in question. Thus all checks, promissory notes, and drafts are negotiable as they can be passed on to another by endorsement.
- Open shop. A shop in which anyone may work whether he belongs to a union or not.
- **OPA** (Office of Price Administration). The government agency set up to regulate prices and rationed goods during the Second World War.
- Panic. The unreasoned and hasty action of a large number of persons, caused by fear, in which each individual is more interested in his own welfare than in that of others.
- Par value. The nominal or stated value of stocks or bonds as printed on the face of the security. It is an estimated value.
- Paternalism. Government control of the well-being of a people. It is based on the theory that collective judgment is wiser than that of individuals.
- **Picketing.** A method used by organized labor, when on strike, to prevent other laborers from obtaining work in the shop against which there is a strike.
- **Pool.** A secret unwritten agreement among rivals to divide business, profits, and territory. It is intended to eliminate competition to a large extent.
- Price. Value expressed in terms of money.
- **Price ceiling.** A top-price level set by law. A seller of goods must not charge more than this price.
- **Price level.** The average price of a series of commodities over a definite period of time. Generally expressed in per cents.
- Priority system. A method of controlling the distribution of scarce materials. By means of individual certificates, preferential rating, and allocations, the War Production Board directed the flow of critical materials into war-production channels.
- **Profit sharing.** A principle of distributing income whereby the workmen in an industry receive, in addition to their regular wages, a share in the profits of the concern which would ordinarily go to the owners.

- **Proletariat.** Workers who own no capital goods and are entirely dependent upon wages.
- **Promoter.** One who initiates an enterprise and carries it through the beginning stages before turning it over to the actual managers.
- **Public utilities.** Those businesses which deal in services or products that are essential to the public, such as gas, electricity, telephone, and water supply. They are given a charter by government and exercise a monopoly but are subject to regulation by a commission.
- Radical. A person who believes in making fundamental changes in social institutions or forms of government. He is usually extreme in his ideas. Bolshevists, communists, socialists, and anarchists are often called "radicals."
- Rationing. Allotment of scarce foods or goods under government regulation so that there may be a more equal distribution to all concerned.
- **Rebate.** A deduction. The paying back of some part of the charges that have been made for a service or commodity.
- RFC (Reconstruction Finance Corporation). A corporation created by Congress to aid in financing railroads, banks, insurance companies, and industries, in an effort to put them on a prosperous footing.
- Sabotage. Sometimes called a "strike on the job." The workers do not quit work but damage machinery and goods in an effort to force employers to agree to their demands. May be merely a restriction of output.
- **Scab.** A name given by unions to one who applies for employment where a strike is in progress.
- **Social insurance.** Insurance by the government, including health, accident, old-age, and unemployment insurance.
- **Socialism.** An economic system that would have the government or guilds of workers own and operate all large industries, thus restricting private enterprise.
- Soviet. The basis upon which the present government of Russia rests. It is essentially occupational rather than territorial representation. A council, usually made up of Russian workmen and soldiers.
- Specie. Coin, usually gold or silver. Hard money.
- **Speculator.** One who buys and sells for the sole purpose of making a profit from a change in market prices.
- Stabilize. To make steady or to reduce fluctuations.
- Standardization. The process of reducing things to a common standard.

  A feature of large-scale production.
- Stock exchange. A place where stocks and bonds are bought and sold through brokers.
- Subsidy. A sum of money granted by the state to assist in the establishment or support of an enterprise which is considered to be of some advantage

- to the public. Subsidies are granted chiefly to railroads, steamship lines, and farmers.
- Sumptuary law. A law designed to prevent the consumption of goods considered harmful to the health or welfare of society. The prohibition law is an example. The term also applies to any law that regulates or restricts the consumption of goods by the public.
- Sweating system. A term used to describe a method of treating employees by taking advantage of their necessities to force them to the limit of their endurance and ability for the lowest possible wage. Homework under very unhealthful conditions.
- Tax. A sum imposed on individuals, firms, and corporations by the government in order to raise funds. Income and property may be taxed.
- **Technological.** Relating to technology. A term commonly used to designate anything connected with machinery, as technological unemployment—unemployment caused by the use of machinery. It is also used to refer to special skill or knowledge.
- TVA (Tennessee Valley Authority). A part of the New Deal which maintains and operates the properties owned by the United States at Muscle Shoals in Alabama in the interests of national defense and for the development of agriculture and industry in the Tennessee Valley.
- **Trade association.** An association of all the dealers engaged in a particular trade. First to be formed was the Writing Paper Manufacturers Association. Chambers of Commerce are, in a sense, trade associations, although more general.
- Unearned increment. An increase in the value of property for which society and not the individual is often responsible.
- Utility. Ability of a good to gratify a human want. Value in use.
- Utopia. A word used to designate the perfect society. It is taken from the title of a book written by Sir Thomas More, in which he described such a society.
- Value. Ability of one good to command another in exchange.
- WLB (War Labor Board). A government board established during the Second World War to regulate and control the relations between labor and capital.
- Watered stock. Extra shares in the ownership of a corporation, issued to stockholders in order to divide the value of the existing property into a larger number of shares.
- "White-collar" group. An expression applied to those who work in offices or in professions, in contrast to the "hard-handed" group, who work on machines or at manual labor.

- Workmen's compensation laws. Laws designed to compel employers to assume financial liability in case of accidents to employees when the accidents arise out of the employment.
- "Yellow-dog" contract. A contract signed by a worker, by which he agrees not to join a labor union while working for the employer. In such cases, the worker is usually forced to sign the contract in order to obtain the job.

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